TAXATION OF WORKERS' COMPENSATION FUNDS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

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TAXATION OF WORKERS' COMPENSATION FUNDS

TUESDAY, APRIL 7, 1987

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:18 a.m., in room B-318, Rayburn House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
FRIDAY, MARCH 13, 1987

PRESS RELEASE #2
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-3627

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING ON THE TAXATION OF WORKERS' COMPENSATION FUNDS

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing on the issues regarding the proper tax treatment of workers' compensation funds, which are currently subject to a one-year moratorium under section 1879(q) of the Tax Reform Act of 1986. The hearing will be held on Tuesday, April 7, 1987, at 10:00 a.m. in Room B-318 Rayburn House Office Building.

In announcing the hearing, Chairman Rangel stated, "The Tax Reform Act of 1986 contains a one-year moratorium on nationwide audits of certain workers' compensation funds. This moratorium ends on August 16, 1987. The Subcommittee will consider the appropriate classification of these entities for tax purposes, and review issues regarding the deductibility of policyholder dividends by these entities."

BACKGROUND

Certain unions and other workers' groups have organized pooled self-insurance funds in order to satisfy State workers' compensation laws. In general, these funds are organized as mutual property and casualty insurance companies. The Internal Revenue Service has audited certain funds, questioning the classification of the entities as mutual companies, and questioning the timing and appropriateness of the deduction of policyholder dividends of the companies.

Section 1879(q) of the Tax Reform Act of 1986 imposes a one-year moratorium on these audits to allow time for study of the appropriate classification of these entities, and the propriety of the timing of deductions for policyholder dividends.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-3627] no later than Friday, March 27, 1987, to be followed by a formal written request to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. (See formatting requirements enclosed.) This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

(MORE)

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 100 copies of their prepared statements to the Subcommittee office, 1111 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Wednesday, April 15, 1987, to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, 1111 Longworth Building House Office Building, before the hearing begins.

SEE ENCLOSED FORMATTING REQUIREMENTS.

* * * * * * *

Chairman **Rangel**. The Select Revenue Measures Subcommittee will come to order.

We welcome everyone attending these hearings on the proper tax treatment of mutual workmen's compensation plans. The Tax Reform Act of 1986 directs the Secretary of the Treasury to suspend all pending audits of self-insuring workers' compensation funds where the issue is whether such a fund is a mutual insurance company.

This hearing will provide the subcommittee with an opportunity to review the law concerning the proper treatment of these funds, and the concerns of the Internal Revenue, as well as the impact on the employers that have established these funds.

Several issues will be considered, including a review of the proper tax treatment of payments made to these funds, and the appropriate tax classification of these funds. In addition, the subcommittee will review the proper treatment of specific amounts deducted in the past years of certain funds.

My friend and colleague, Guy Vander Jagt, wanted to be here this morning but has been unavoidably detained in his district. But I look forward to having the benefit of his views.

Will he be coming later on this morning?

Staff. Yes.

Chairman **Rangel**. We look forward to having his input in these hearings since it has been his long-standing concern to protect these groups' self-insured workers' compensation, not only in Washington, but in his home State of Michigan. And last year he was the prime mover behind the moratorium which is locked into place right now.

Because of the several complex issues that have to be reviewed by this committee this morning, with the exception of the representative from the Treasury Department, I will ask the people testifying to submit their full statements and to restrict their oral testimony to 5 minutes.

The Chair yields to Mr. Flippo.

Mr. **Flippo**. Thank you, Mr. Chairman.

I just want to thank you for holding these hearings on this very important matter. These funds would not have been created, I suppose, if they had had some other alternatives to begin with so it is a matter of great importance to so many people. I commend you for having these hearings.

Chairman **Rangel**. I am glad you have an open mind on this.

Mr. **Flippo**. It is totally an open mind. [Laughter.]

Mr. **Brown**. Mr. Chairman, I want to also commend you for holding these hearings. We look forward to the testimony that is going to be presented.

This particular area is one that I think all of us share a common concern that they be adequately funded and properly run. We look forward to an opportunity to making sure that objective that all of us share is met.

Chairman **Rangel**. Well, this is the first appearance of the Special Assistant to the Assistant Secretary for Tax Policy, and we hope that we will be seeing a lot of you and, of course, you are not restricted to the 5 minutes because you are going to, in addition to your testimony, show reason why the IRS will not cause bankruptcy chaos and put employees on welfare——

Ms. CARLISLE. I hope I do have considerably more than 5 minutes.

Chairman RANGEL. And certainly all of the things that America has stood for over the years, why these should not be changed, and to dismantle the arsenal of America and all of those un-American things that you are proposing.

You may proceed.

Ms. CARLISLE. Thank you, Mr. Chairman.

Mr. FLIPPO. I am glad the Chair has an open mind. [Laughter.]

STATEMENT OF LINDA E. CARLISLE, SPECIAL ASSISTANT TO THE ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Ms. CARLISLE. I am too.

Mr. Chairman and members of the subcommittee, I am——

Chairman RANGEL. Excuse me. If you will pause. Knowing the deep-seated interest that the gentleman from Michigan has on this, I would want him to state for the record if he has any immediate concern before the administration's testimony.

Mr. LEVIN. No. I just appreciate the invitation to join you for this hearing. I am glad to sit in this most distinguished and powerful subcommittee.

Mr. BROWN. Another open mind.

Chairman RANGEL. I am sorry for the interruption.

Ms. CARLISLE. I am pleased to have this opportunity this morning to present the views of the Treasury Department regarding the Federal income taxation of self-insured workers' compensation associations. These associations, as you all know, are currently the subject of a 1-year moratorium adopted in the Tax Reform Act of 1986. This moratorium bars the Internal Revenue Service from pursuing certain issues on audit. In addition, Representative Vander Jagt has introduced legislation that would grant tax exempt status to these associations.

In my testimony this morning, I would like to discuss the administration's position vis-a-vis extension of the moratorium and what we believe to be the proper treatment of workers' compensation associations.

Chairman RANGEL. You could assume that we are familiar with the plans.

Ms. CARLISLE. That is wonderful.

As you will see in the testimony for the record, the Treasury Department has provided a background as to the structure and organization of certain welfare compensation associations in various States.

Using, for example, Michigan and their laws, I would like to point out just a few things about the structure of such associations.

Generally, as everyone does know, an injured employee is entitled to workmen's compensation benefits without regard to the negligence or fault of the employer. Most State workers' compensation laws impose liability directly on the employer. Therefore, an employer generally has two ways or two methods available to him or her to insure against this risk.

An employer may insure through a commercial insurance company, and a number of States permit employers to self-insure the risks on an individual basis.

Michigan, for example, allows employers to self-insure upon a demonstration of their solvency and financial ability to pay. Self-insurance of workers' compensation liabilities offers employers a potential cost savings over regular commercial insurance.

In order to make this benefit available to employers that do not have sufficient assets to self-insure on an individual basis, many States, such as Michigan, authorize the establishment of self-insured workers' compensation associations, the subject matter of this hearing. Generally, these associations consist of a group of employers that voluntarily pool their funds in order to insure their collective liability for workers' compensation claims.

The structure of such associations varies, depending upon State law and the agreement among the individual employees.

Typically, however, and this is a key point, these associations pool employer contributions and draw on such amounts and the investment income earned thereon to pay workers' compensation to employees of participating employers. All claims are made against and paid out of the pool funds. Separate accounts are not maintained for each individual participating employer.

Also, self-insured workers' compensation associations are permitted to distribute to participating employers surplus assets. That is, assets in excess the amount of estimated necessary to pay claims against the association.

A participating employer's share of such surplus assets is based on its share of total contributions and the distribution generally reflects the experience of the association as a whole rather than the experience of the one individual employer.

Self-insured workers' compensation associations are generally subject to State regulation, and that State regulation includes a determination of the amount of the distribution of surplus assets to participating employees.

At this time, the Service has audited a number of workers' compensation associations for taxable years beginning before 1984. Although the scope of the audit of each individual audit varies with the facts and circumstances of each case, two issues have commonly arisen.

No. 1, whether the association may be properly characterized as a mutual insurance company.

And, No. 2, whether the association may claim a deduction for surplus asset distributions before the distributions have received State approval.

The Tax Reform Act, as I noted earlier, bars the Service during the 1-year period ending on August 16, 1987, from initiating or continuing any audit or collection activities, with respect to the issue of whether a self-insured workers' compensation association is a mutual insurance company.

The Service, however, has interpreted the moratorium as preserving the status quo with respect to all issues raised in audits of workers' compensation associations.

Although the Service initially questioned the classification of associations as mutual insurance companies, it has since concluded, at least in the cases it has thus far examined, that workers' compensation associations possess the requisite characteristics of a mutual insurance company. However, the treatment of self-insured workers' compensation associations as mutual insurance companies presupposes that the associations provide insurance rather than, as their name suggests, self-insurance.

For tax purposes, an insurance company is a company whose primary purpose is the issuing of insurance contracts. An insurance contract, for tax purposes, is a contract involving both the shifting and the distribution of risk among a group of economically unrelated entities.

To the extent that employer contributions to a workers' compensation association are at risk to pay claims attributable to other employers, and distributions are based on the experience of the association as a whole, the association exhibits the risk shifting and risk distribution characteristics of insurance.

In contrast, each employer will be treated for tax purposes as self-insuring if its workers' compensation liability were retained, that is, if it had retained the economic risk of loss and premiums and distributions were based solely on its own experience.

The second issue that has been raised in the Internal Revenue Service audits has been the proper timing of the accrual of policyholder dividends. A mutual property and casualty insurance company that is subject to tax on its underwriting income, may deduct dividends paid or declared to policyholders.

In our view, a property and casualty company is required to calculate its deduction for policyholder dividends under the method of accounting, either cash or accrual, that is generally utilized by the company. Thus, for an accrual method taxpayer, an item of deduction does not accrue until the taxable year in which all of the events have occurred that determine the fact of the liability and permit the amount of the liability to be determined with reasonable accuracy.

In addition, section 461(h) of the code provides that the all events test with respect to certain items is not met earlier than when economic performance with respect to such item occurs.

Accordingly, under the all events test, a self-insured workers' compensation association may not deduct a policyholder dividend where distribution of the dividend is contingent upon State regulatory authority, and such approval has not yet been received.

The audit moratorium is schedule to expire, as I noted, on August 16. We believe that extension of the moratorium is inappropriate. The questions raised in the Service's audit of self-insured workers' compensation associations are of the type that routinely arise in the audit process. And a moratorium substantially interferes with that process and should only be imposed under extraordinary circumstances. No such extraordinary circumstances are present, and the issue concerning the taxation of workers' compensation associations should be resolved through the regular administrative and judicial process.

Now, with respect to the two bills that have been introduced by Representative Vander Jagt to grant tax exempt status to self-insured workers' compensation associations with retroactive application to all prior years, the Treasury Department must state its opposition.

Workers' compensation associations serve the same practical function as insurance companies and therefore should be subject to tax in the same manner. Granting tax exempt status to self-insured workers' compensation associations would put other taxable insurance companies at an unjustifiable competitive disadvantage.

Similar concerns led to the adoption in the Tax Reform Act of new restrictions on insurance activities of otherwise tax exempt entities. The same principles that supported these new restrictions also argue that tax exempt status not be extended to workers' compensation associations.

In our examination of the tax treatment of workers' compensation associations, we have reviewed the relationship between the tax rules applicable to insurance companies and the rules enacted in the 1984 Tax Act (DEFRA) governing welfare benefit funds. Our review indicates that the rules governing welfare benefit funds may inappropriately apply to certain organizations, such as workers' compensation associations that are otherwise subject to taxation as insurance companies.

The DEFRA rules for welfare benefit funds govern the tax treatment of certain organizations or arrangements that permit an employer to self-insure welfare benefits. In general, these rules are intended to minimize the tax considerations with respect to an employer's decision to insure or to self-insure. The rules in general do two things: they restrict employer deductions for contributions and restrict the tax favored treatment of investment income in a fund to reasonable actuarially determined amounts for the claims.

An exception from the DEFRA limits on employer deductions is provided for welfare benefit funds that exhibit significant risk distribution, that is, funds where 10 or more unrelated employers contribute to the fund, and no individual employer contributes more than 10 percent of the total contributions, a so-called 10 or more employer fund.

The limits on tax favored treatment of investment income, however, which are analogous to the rules applicable to commercial insurance companies continue to apply.

The DEFRA rules generally define a welfare benefit fund as including certain tax exempt organizations, certain individual accounts held for an employer by another person and, most importantly, any trust corporation or other organization not exempt from tax that is used by an employer to provide welfare benefits to employees.

In our view, self-insured workers' compensation associations meet the literal definition of a welfare benefit fund since they are organizations not exempt from tax and are used to provide welfare benefits to employees.

Thus, for taxable years beginning after 1985, these associations are subject to two regimens: the DEFRA rules for welfare benefit plans, and the rules for the taxation of insurance companies. This overlap of rules is not unique to workers' compensation benefits, but may exist with respect to other welfare benefits.

To limit the substantive overlap, we recommend that the definition of welfare benefit fund be modified to exclude organizations that are taxable as insurance companies and satisfy the 10 or more employer rule. This will have the effect of reducing complexity for such associations so that they are not subject to two similar, but different regimens.

Mr. Chairman, this concludes my prepared testimony. I will be happy to answer any questions.

[The prepared statement follows:]

For Release Upon Delivery
Expected at 10:00 a.m., E.D.T.
April 7, 1987

STATEMENT OF
LINDA E. CARLISLE
SPECIAL ASSISTANT TO THE
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to present the views of the Treasury Department regarding the Federal income taxation of self-insured workers' compensation associations. These associations currently are the subject of a one-year moratorium, adopted in the Tax Reform Act of 1986 (the "Tax Reform Act"), which bars the Internal Revenue Service (the "Service") from pursuing certain issues on audit. In addition, legislation recently has been introduced that would grant tax-exempt status to these associations.

This hearing presents an opportunity to discuss a number of significant issues concerning the taxation of self-insured workers' compensation associations. Certain of these issues have arisen in the ordinary audit process and are of a type that routinely arises in connection with commercial insurance activities. We believe these issues should be resolved through the regular administrative and judicial process, and for that reason oppose any extension of the current moratorium.

Issues of much broader concern, however, are raised by H.R. 1489 and H.R. 1709, legislation recently introduced by Representative Vander Jagt, that would grant tax-exempt status to self-insured workers' compensation associations. We believe these associations serve the same practical function as commercial insurance companies, and should be subject to Federal income taxation under the general rules that apply to such companies. Accordingly, we oppose any legislation that would grant tax-exempt status to self-insured workers' compensation associations.

Finally, several issues concerning self-insured workers' compensation associations arise under the Deficit Reduction Act of 1984 ("DEFRA"), which adopted new rules governing the tax treatment of welfare benefit funds. Since these new rules generally became effective for years after 1985, their possible application to self-insured workers' compensation associations has not yet been addressed in the audit process. In general, however, we believe that the welfare benefit fund rules should not apply to self-insured workers' compensation associations, and that the DEFRA rules should be modified to make this result certain.

BACKGROUND

Before discussing the various issues relating to the taxation of self-insured workers' compensation associations, I would like briefly to describe state workers' compensation laws and the structure of self-insured workers' compensation associations.

State Workers' Compensation Laws. State workers' compensation laws are designed to guarantee that compensation is provided to employees and their beneficiaries for an employee's injury, disability or death incurred in the course of employment. Workers' compensation laws generally entitle an injured employee to benefits without regard to the negligence or fault of the employer. An employee who is entitled to no-fault benefits under the workers' compensation law may not also recover under the otherwise applicable state tort law.

State workers' compensation laws generally prescribe a schedule of compensation to be paid to an employee depending on the type of injury or degree of disability incurred. In the case of an employment-related injury that results in either partial or total disability, the scheduled compensation typically will replace a specified portion of the employee's pre-injury wages for the duration of the disability. In the case of an injury that does not result in disability, compensation is provided in the form of a lump-sum payment the amount of which depends on the type of injury.

Most state workers' compensation laws impose liability for workers' compensation benefits directly on the employer. Although an employer may insure its risk of liability with a commercial insurance company, a number of states permit certain employers to self-insure the risk on an individual basis. Michigan, for example, allows employers to self-insure upon a demonstration of their solvency and financial ability to pay workers' compensation benefits.

The ability to self-insure workers' compensation liabilities offers employers a potential cost savings over regular commercial insurance. In order to make this benefit available to employers that do not have sufficient assets to self-insure on an individual basis, many state workers' compensation laws authorize the establishment of self-insured workers' compensation associations. These associations generally consist of a group of employers that voluntarily pool funds in order to insure their collective workers' compensation liability. Again taking Michigan as an example, a group of employers in the same industry may establish a self-insured association if the members of the group have combined assets of at least one million dollars.

Self-Insured Workers' Compensation Associations. The structure of self-insured workers' compensation associations differs depending on state law and the terms of the agreement among the participating employers. Typically, however, self-insured associations are formed by employers in a common industry, with each employer required to make an annual contribution based on the size of the employer's work force and its experience with workers' compensation claims. The association pools employer contributions and draws on such amounts (and the investment income earned thereon) to pay workers' compensation benefits to employees of participating employers. All claims are made against and paid out of the pooled funds; separate accounts are not maintained for the contributions or employee claims of particular employers.

Self-insured workers' compensation associations are ordinarily permitted to distribute to participating employers "surplus" assets, *i.e.*, assets in excess of the estimated amount necessary to pay claims against the association, both reported and unreported, as of the end of the year. A participating employer's share of such surplus assets is based on its share of the total contributions to the association for the year. In some cases, associations may also make special distributions to employers that withdraw from an association. Since an association generally does not maintain separate accounts for each employer's contributions, the distribution of association assets to any particular employer generally reflects the experience of the association as a whole rather than the experience of that employer.

Self-insured workers' compensation associations are generally subject to state regulation and thus may not make distributions of surplus assets until the relevant state authority has granted approval. State approval of a surplus distribution is based on the state's independent determination of the amount that an association must hold in reserve for outstanding claims. State regulatory authorities may make a conservative estimate of this amount in order to assure that adequate funds are available to pay all required benefits.

DISCUSSION

A. Audit Moratorium

The Service has audited a number of workers' compensation associations for taxable years before 1985. Although the scope of specific audits varies with the particular circumstances, two issues have commonly arisen in audits of such associations: (i) whether the association may appropriately be characterized as a mutual insurance company; and (ii) whether the association may claim a deduction for surplus asset distributions before such distributions have received state approval.

Section 1879(q) of the Tax Reform Act bars the Service during the one-year period ending on August 16, 1987, from initiating or continuing any audit or collection activities with respect to the issue of whether a self-insured worker's compensation association is a mutual insurance company. Although the Tax Reform Act did not specifically address any other audit issue, the Service has treated the moratorium as preserving the status quo with respect to all issues raised in audits of workers' compensation associations.1/

1. Classification as Mutual Insurance Companies. The express subject matter of the audit moratorium is the ability of workers' compensation associations to treat themselves as mutual property and casualty insurance companies (taxable under part II of Subchapter L of the Internal Revenue Code of 1954). Although the Service initially questioned such treatment (and asserted that the associations were non-mutual property and casualty companies taxable under part III of Subchapter L), it has since concluded that, at least in the cases it has examined, workers' compensation associations possess the requisite characteristics of mutual insurance companies.2/

1/ In letters to Representatives Dingell and Vander Jagt dated January 29, 1987, the Service stated that it will not pursue collection activities and will take no other actions against an association during the moratorium period except to the extent necessary to prevent the expiration of the statute of limitations with respect to any tax year of an association.

2/ We note that the issue of whether an association is a mutual insurance company, while relevant under pre-1987 law, is no longer significant because the Tax Reform Act merged parts II and III of Subchapter L, eliminating the distinctions in the tax treatment of mutual and stock property and casualty insurance companies.

The treatment of self-insured workers' compensation associations as mutual insurance companies presupposes that the associations provide insurance rather than, as their name suggests, a form of self-insurance.[3] For tax purposes, an "insurance company" is "a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts." Treas. Reg. 1.801-3(a). A contract or arrangement is an insurance contract if it involves the shifting and distribution of risk among a group of economically unrelated entities. See Helvering v. Le Gierse, 312 U.S. 531 (1941); Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981), cert. den., 454 U.S. 965 (1981). In addition, an insurance company that primarily provides insurance other than life insurance is taxed as a property and casualty company.

Ordinarily, the sole activity of self-insured workers' compensation associations is to pay workers' compensation benefits to the employees of participating employers. To the extent that employer contributions are at risk to pay claims attributable to other employers and distributions are based on the experience of the association as a whole rather than of individual employers, the association exhibits the risk shifting and risk distribution characteristics of insurance.[4] This is the case even though state authorizing statutes may consider such associations a form of self-insurance. For tax purposes, an employer would be treated as self-insuring its workers' compensation liability if it has retained the economic risk of loss. In this respect, an association would be treated as providing self-insurance if, for example, each employer's premiums and distributions were based on its own experience.

2. Proper Accrual of Policyholder Dividends. A mutual property and casualty insurance company that is subject to tax on its underwriting income may deduct dividends "paid or declared" to policyholders.[5] Section 822 of the Internal Revenue Code of 1954; section 832 of the Internal Revenue Code of 1986 (the "Code"). Treasury regulations provide that, in the case of a cash method property and casualty company, the deduction for policyholder dividends is limited to the dividends actually paid during the taxable year. In the case of an accrual method property and casualty insurance company, the regulations restate the paid or declared standard of the statute. Treas. Reg. 1.822-12(b).

In our view, the statute and the regulations require a property and casualty company to calculate its deduction for policyholder dividends under the method of accounting -- cash or accrual -- that is generally utilized by the company. Thus, in the case of an accrual method taxpayer, the standard for deducting policyholder dividends is the accrual standard provided in section 461 of the Code and the regulations thereunder. That standard provides that an item of deduction does not accrue until the taxable year in which all of the events have occurred that determine the fact of the liability and permit the amount of the liability to be determined with reasonable accuracy. In addition, section 461(h) provides that the all events test with respect to certain items is not met earlier than when economic performance with respect to that item occurs.

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[3] Because insurance companies may deduct additions to reserves for losses, while taxpayers that self-insure may not, characterization of a contract or arrangement as insurance is advantageous for Federal income tax purposes. The advantage of insurance over self-insurance was reduced, but not eliminated, by the Tax Reform Act's requirement that insurance companies discount loss reserves.

[4] The number of employers in an association and the share of risk borne by each would also bear on whether there is sufficient risk shifting and distribution to constitute insurance. The Service has ruled in Rev. Rul. 83-172, 1983-2 C.B. 107, that an association consisting of forty employers, where no individual employer provided more than five percent of the risk, constitutued an insurance company for Federal tax purposes.

Under the all events test, a self-insured workers' compensation association may not deduct a policyholder dividend where, as of the end of the taxable year, distribution of the dividend is contingent on approval by a state regulatory authority that has not been received. In such cases, employers are unable to require the distribution of any amount until the distribution is approved by the state body. Accordingly, the fact of the association's liability to make the distribution is not fixed until the distribution is approved. Moreover, because the state regulatory body may independently determine the minimum reserve necessary to satisfy the association's reported and unreported claims, the amount of the policyholder dividend cannot be determined with reasonable accuracy until the body has made its determination.

Self-insured workers' compensation associations may argue that the deduction of policyholder dividends by an accrual method property and casualty insurance company is not subject to the all events test, but rather is subject to some less rigorous standard. If this were the case, the associations could argue that the distributions are deductible in the year they are designated, regardless of the date of accrual or the date of actual distribution.

As stated above, we believe that the all events test is the proper standard for determining when an accrual method property and casualty insurance company may deduct policyholder dividends. Application of any lesser standard would enable the associations and their participating employers to achieve a significant mismatching of income and deductions. This mismatching would result because the association could deduct the distributions prior to state approval while accrual method participating employers presumably would not include the distributions in income until the state has approved the distribution. We also note that in DEFRA, as part of the restructuring of the rules for taxing life insurance companies, Congress specifically considered the proper timing of the deduction for policyholder dividends by life insurance companies, and permitted the deduction of only those dividends that are paid or accrued during the taxable year.[6/]

3. Expiration of the Audit Moratorium. The audit moratorium is scheduled to expire on August 16, 1987. We believe the moratorium is inappropriate and should not be extended. The questions raised in the Service's audit of self-insured workers'

[5/] In general, a property and casualty insurance company is taxable on its underwriting income unless it has net written premiums of less than $350,000, in which case it is fully exempt from tax under section 501(c)(15) of the Code or has net written premiums of less than $1.2 million and elects to be taxed only on its investment income.

[6/] Under prior law, life insurance companies were permitted by statute to deduct additions to a reserve for policyholder dividends payable during the following taxable year.

compensation associations are of a type that routinely arises between taxpayers and the Service in the audit process. A moratorium substantially interferes with that process and should be imposed only under extraordinary circumstances. No such circumstances are present with respect to workers' compensation associations, and the issues concerning their taxation should be resolved through the regular administrative and judicial process.

B. Proposed Legislation

Two bills, H.R. 1489 and H.R. 1709, have been introduced to grant tax-exempt status to self-insured workers' compensation associations, with retroactive application for all prior years. The Treasury Department opposes this legislation. Workers' compensation associations serve the same practical function as commercial insurance companies and should be subject to tax in the same manner. Unlike charitable, religious and educational organizations, which are granted tax-exempt status because of their special, quasi-public purposes, workers' compensation associations are operated for the exclusive benefit of the participating employers, providing a reduced-cost alternative to commercially provided insurance.

Granting tax-exempt status to self-insured workers' compensation associations would put other, taxable insurance companies at an unjustifiable competitive disadvantage. Similar concerns led to the adoption in the Tax Reform Act of new restrictions on insurance activities of otherwise tax-exempt entities. Thus, under new section 501(m) of the Code, a charitable or social welfare organization that provides "commercial-type insurance" is, depending on the extent of its insurance activities, ineligible for tax-exempt status or subject to tax on its income from insurance activities. The same principles that supported these new restrictions also argue that tax-exempt status not be extended to workers' compensation associations.

C. Issues Arising Under DEFRA

In examining the tax treatment of self-insured workers' compensation associations, we have reviewed the relationship between the tax rules applicable to insurance companies and the DEFRA rules governing welfare benefit funds. Our review indicates that the rules governing welfare benefit funds may inappropriately apply to certain organizations, such as workers' compensation associations, that are otherwise subject to taxation as insurance companies.

The DEFRA rules for welfare benefit funds govern the tax treatment of certain organizations or arrangements that permit an employer to self-insure welfare benefits, such as employee medical and disability benefits. In general, the rules are intended to minimize the effect of tax considerations on an employer's decision to insure or to self-insure such benefits. Thus, the rules restrict employer deductions for contributions to a welfare benefit fund, so as to limit the ability of self-insuring employers to pre-fund future benefits.7/

7/ The DEFRA rules, which are contained in sections 419, 419A and 512 of the Code, do not override other deduction rules that may apply with respect to contributions to a welfare benefit fund. In this regard, section 461(h)(2)(C) of the Code provides that if an employer's liability to pay another person arises under a workers' compensation law, accrual of a deduction cannot occur prior to payment to such person. This rule may also affect the extent to which income on amounts held by a fund to provide workers' compensation benefits are subject to tax under the DEFRA rules.

Similarly, the rules restrict the tax-favored treatment of investment income to the extent the fund exceeds a reasonable, actuarially determined amount for incurred claims.[8]

An exception from the DEFRA limits on employer deductions is provided for welfare benefit funds that exhibit sufficient risk distribution such that no single employer has a significant residual interest in its own contributions or the assets of the fund. Thus, if ten or more unrelated employers contribute to a fund and no individual employer's contribution normally exceeds ten percent of the total contributions to the fund (a so-called "ten-or-more employer fund"), the DEFRA limits on an employer's deductions do not apply. Although ten-or-more employer funds remain subject to the limits on tax-favored treatment of investment income, these limits are analogous to the rules applicable to commercial insurance companies. That is, under both the DEFRA rules and the insurance company rules, investment income not needed to fund the payment of current benefits and a reserve for incurred claims payable in the future is subject to tax.

The DEFRA rules generally define a "welfare benefit fund" broadly to include any of the following entities to the extent used by an employer provide welfare benefits to employees: (i) any tax-exempt organization described in section 501(c)(7), (9), (17), or (20); (ii) any trust, corporation or other organization not exempt from tax; and (iii) to the extent provided in regulations, any account held for an employer by another person (e.g., an insurance company). In our view, self-insured workers' compensation associations meet the literal definition of a welfare benefit fund since they are organizations not exempt from tax and are used to provide welfare benefits to employees. Thus, for years beginning after 1985, these associations are subject both to the DEFRA rules taxing a portion of their investment income and to the rules taxing the income of insurance companies. In addition, for associations that fail to qualify as ten-or-more employer funds, the DEFRA limits on employer deductions would be applicable. This overlap of rules is not unique to workers' compensation benfits, but may exist with respect to other welfare benefits.

We recommend that the definition of "welfare benefit fund" be modified to limit this substantive overlap by excluding organizations that are taxable as insurance companies and also satisfy the ten-or-more employer fund rule.[9] For such organizations, the DEFRA rules approximate the rules applicable to insurance companies, and application of both tax regimes is unnecessary. Applying the ten-or-more employer fund requirement would provide important additional assurance that risk distribution occurs in the organization.

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[8] The DEFRA rules do not explicitly provide an allowable reserve amount for workers' compensation benefits. However, to the extent they are in the nature of disability benefits, workers' compensation benefits should be treated as disability benefits in applying the DEFRA rules.

[9] This recommendation is consistent with a modification to the definition of a welfare benefit fund enacted in the Tax Reform Act. This modification excluded from the definition of that term amounts held by an insurance company pursuant to an insurance contract purchased by an employer where the employer does not retain a significant residual interest in the amounts.

CONCLUSION

The proper classification for Federal income tax purposes of self-insured workers' compensation associations, and the timing of their deductions for distributions of surplus assets to participating employers, raise significant questions of law and fact. These questions should be addressed through the regular process of tax administration, which commences with audit but includes opportunities for both administrative and judicial review. In order to permit that process to go forward, the moratorium barring Service audits of workers' compensation associations should be allowed to expire. In addition, we believe workers' compensation associations should generally be taxed in the same manner as commercial insurance companies, and thus we oppose legislation that would grant tax-exempt status to these associations. Finally, we recommend modifications to the welfare benefit fund definition adopted in DEFRA to clarify the interaction of those rules with the separate rules applicable to insurance companies.

Chairman **Rangel**. Ms. Carlisle, has IRS received complaints from the private insurance companies over these self-insured funds programs?

Ms. **Carlisle**. Mr. Chairman, I am not quite sure what you mean, complaints.

Chairman **Rangel**. Well, you claim if we made them tax exempt that it would be unfair to the private insurance companies that handle these type of things. And I just was wondering whether they have been in communication with the Service.

Ms. **Carlisle**. Not that I know of, Mr. Chairman.

Chairman **Rangel**. Do you know how many States have these type of self-insured plans?

Ms. **Carlisle**. I think it is approximately half, Mr. Chairman.

Chairman **Rangel**. Half of the States?

Ms. **Carlisle**. Yes.

Chairman **Rangel**. Did you deal with the question of equity and fairness? If, in fact, the IRS, for over a decade, has been treating these firms with a different tax status that now in reviewing them, that some companies claim that they would owe millions of dollars in back taxes, and they had no reason to believe that they would be treated as having tax liability? Is that so?

Ms. **Carlisle**. Mr. Chairman, I would imagine that that claim is referring to the proper timing of the deductions for policyholder dividends, a subject that is live in the audit process and is being disputed between the taxpayer and the Internal Revenue Service.

This is an issue that, in our view, is ripe for judicial determination if there continues to be a difference of opinion between the taxpayer and the Service through the administrative process.

Chairman **Rangel**. But if the taxpayer relied on the rules and regulations of the Service for 10 years and not have tax liability, do you believe that they should have a liability extending back for the 10 years?

Ms. **Carlisle**. Mr. Chairman, I am not certain as to which rules or regulations that the Service has promulgated that would cause a taxpayer to detrimentally rely for the past 10 years.

Chairman **Rangel**. Well, in reviewing some of the testimony of the taxpayers that are going to be affected, they allege that the payment of these taxes could cause bankruptcy and force employees on welfare. Has the Service reviewed any of these responses?

Ms. **Carlisle**. Not that I know of, Mr. Chairman.

Chairman **Rangel**. What?

Ms. **Carlisle**. No, not that I know of.

Chairman **Rangel**. Well, do you have any idea what economic effect it would have if we allowed the moratorium to expire?

Ms. **Carlisle**. I do not. But I can certainly ask our Department to see if they can come up with some kind of a determination.

The moratorium would merely allow the administrative process to continue vis-a-vis the audits of these associations.

Chairman **Rangel**. But if the imposition of this tax caused major companies throughout the United States to go out of business, is this a consideration of the Service?

Ms. **Carlisle**. Yes, Mr. Chairman, most certainly it is. But rescinding the moratorium or not allowing the moratorium to continue, as wishful as the Service may be, does not mean that the issue is resolved against the taxpayer in favor of the Service. It merely means that the audit process may continue, and if there continues to be a dispute between the taxpayer and the Service, the courts then are involved to determine what is the appropriate treatment of prior law.

Chairman Rangel. But if the legislation before the committee is supported and is passed into law, then that issue would not be before the courts.

Ms. Carlisle. That is correct. What that legislation would do is retroactively change the tax treatment of such associations and make them tax exempt.

The purpose of tax reform in general was to level the playing field among similar entities.

Chairman Rangel. I was an active player in the process.

Ms. Carlisle. I remember quite well, Mr. Chairman.

Chairman Rangel. But my question to you is that if we do not support the legislation before the committee, and we do allow the court's interpretation of existing law, and they do support the Service and the tax liability is imposed on these firms, all I am asking is did the IRS consider the economic impact on these firms, or do you believe that is a proper subject for the Service to review?

Ms. Carlisle. I think it is a proper subject for Congress and the Treasury to review.

Chairman Rangel. Did Treasury review it?

Ms. Carlisle. The Treasury has not specifically looked at the firms that are currently under audit. If you are asking the Treasury to look at the economic impact of an adverse decision, assuming the moratorium is lifted and in litigation the issue is decided against the taxpayer, I would be most happy to get back to you with that information.

Chairman Rangel. Well, I really was not asking you to do it. I was asking do you really think, and I am not being facetious, is that a proper subject matter for the Service since there is legislation that we believe is supposed to relieve an adverse disastrous impact on major corporations throughout the United States causing employees to go on welfare and major arsenals of America to go into bankruptcy, jeopardize us in the free world, and expose us to the terrors of communism?

Ms. Carlisle. And a few other things.

Chairman Rangel. Yes. And I would think that the administration here in these allegations would review it and see whether or not these things could happen.

Ms. Carlisle. To my knowledge, we have not received proof of these allegations, and we have not received data that would so indicate or, most certainly, Mr. Chairman, we would have evaluated that data.

Chairman Rangel. Well, would you believe that one firm might owe $18 million if the moratorium is lifted or expires, or if the legislative relief is not given, that firm would owe the Government $18 million?

Ms. Carlisle. Could I believe it would happen?

Chairman Rangel. You know, I don't know to what extent the IRS has reviewed how much these firms would owe if, indeed, what you are suggesting we do. I mean, how much money would we lose by supporting the Vander Jagt legislation.

Ms. CARLISLE. Very little. [Laughter.]

Mr. FLIPPO. Mr. Chairman, I move we adjourn and pass the bill now. [Applause and laughter.]

I could in no way match the eloquence of the distinguished chairman, but I might want to follow up on his point there.

You mentioned that the Treasury considered this disallowance a timing issue.

Do you think that the amounts—do you really think it is a timing issue, or do you think that the amounts could be permanently disallowed?

Ms. CARLISLE. Well, that, Mr. Flippo, was the reason why I responded very little to Mr. Rangel.

I believe the Service, in making those estimates of an $18 million tax liability, is looking at "total disallowance of the deduction." We do consider it to be a timing issue. That is why, for the initial period, we would consider it to be a not very substantial revenue loss.

Mr. FLIPPO. Could you summarize for us the factors that you think are important in determining what constitutes a deductible premium as opposed to a non-deductible self-insurance?

Ms. CARLISLE. If I have an association where there is sufficient shifting of the risk among unrelated parties, and a distribution of the risk to such unrelated parties, then a payment to such association would constitute a deductible premium.

Mr. FLIPPO. Well, do you think in general that these workmen's compensation funds would qualify under the factors that you talk about as allowing the employer to deduct dividends?

Ms. CARLISLE. Certainly I do, Mr. Flippo. In fact, the Service has so ruled.

Mr. FLIPPO. And what do you think is the best classification of these funds for Federal tax purposes?

Ms. CARLISLE. As a mutual insurance company.

Mr. FLIPPO. And if we applied the mutual tax reform law to them, have you made any determinations as to the impact on these funds?

Ms. CARLISLE. Well, that, Mr. Flippo, is the primary issue in audit that is still left. The Service and the majority of these firms do agree that they are properly characterized as mutual property and casualty insurance companies. And the issue is the deductibility or the timing of the deductibility of policy holder dividends.

Mr. FLIPPO. Thank you.

Thank you, Mr. Chairman.

Chairman RANGEL. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

I cannot imagine how we could have turned over more issues than we have in this particular hearing.

A couple of years ago we imposed, with the help of life insurance companies, additional taxation of life insurance companies. Under the mandate in the tax reform bills, will we do it to them again in 1988.

Once again, the old argument of the mutual companies versus the stock companies arises, as well as the Blue Cross problem from last year. I am looking here at all of the witnesses, and I do not see one commercial insurance company that is going to testify.

Just for the heck of it, how many out there represent commercial insurance companies? Please raise your hand, if you will. No one? There is one. Okay.

Ms. Carlisle, let me ask you a few questions concerning areas other than strictly the bill while you are here, and why the IRS has made the determination that it has made.

Did your audits disclose any of the following practices engaged in by workers' compensation funds:

One, failure to comply with applicable State insurance registration requirements? Please answer, yes or no?

Ms. **Carlisle**. What I am going to have to do, Mr. McGrath, is ask you if I can get back to you with the answers. I do not have that information. That is information that is with the Internal Revenue Service. But I will be happy to respond to you.

Mr. **McGrath**. Thank you. I will read my questions for the record.

Failure to provide and properly file required State insurance form documents of courts; improper investment practices; the investment of assets that are prohibited under applicable State law; failure to make timely or correct workers' compensation payments; general violations of fiduciary duties by officers, directors, trustees, of any of the funds that have been audited; and the revocation of funds, mutual insurance companies' status under applicable State laws.

I believe the answers to these questions are going to go a long way in determining whether or not the legislation that we have before us has merit.

[The following was subsequently received:]

DEPARTMENT OF THE TREASURY
WASHINGTON

May 8, 1987

Dear Mr. McGrath:

At the hearing before the Subcommittee on Select Revenue Measures on April 7 regarding the taxation of self-insured workers' compensation associations, you asked whether the Internal Revenue Service's audits of these associations had disclosed certain practices on the part of these associations. Specifically, you asked whether the audits had disclosed any of the following practices on the part of self-insured workers' compensation associations:

- Failure to comply with applicable state insurance registration requirements;
- Failure to provide and properly file required state insurance form documents.
- Improper investment practices;
- Investment of assets in a manner prohibited by applicable state law;
- Failure to make timely or correct workers' compensation benefit payments;
- General violations of fiduciary duties by officers, directors, or trustees;
- Revocation by a state of a fund's mutual insurance company status under state law.

The Internal Revenue Service has informed us that none of their audits to date has disclosed the practices listed above. We would note, however, that these practices would generally not affect the taxation of an association and therefore would not ordinarily be investigated by an Internal Revenue Service agent in the course of an audit. Accordingly, the fact that the audits have not disclosd any of these practices should not be interpreted to mean that these practices do not exist.

I hope that this information is useful to you. If you have any additional questions, please do not hesitate to let me know.

Sincerely,

Linda E. Carlisle

Linda E. Carlisle
Special Assistant to
the Assistant Secretary for
Tax Policy

The Honorable Raymond J. McGrath
U.S. House of Representatives
Washington, D.C. 20515

Mr. **McGrath**. I should just ask you one additional question.

Is the reasoning behind the fact that you are making this determination regarding these particular funds the fact that last year Congress made a determination that Blue Cross-Blue Shield is not a 501(c) and, therefore, should be taxed just like any other mutual or stock commercial insurance company?

Ms. **Carlisle**. Yes.

Mr. **McGrath**. That is basically the——

Ms. **Carlisle**. That is our rationalization.

Mr. **McGrath**. If Congress made a determination subsequent to the one we made last year that there are some Blue Cross-Blue Shields, or perhaps other insurers of last recourse, that might be eligible for the 501(c) designation, would that change Treasury's attitude towards this issue?

Ms. **Carlisle**. No, sir. I mean that is a Congressional decision.

From a tax policy perspective, what we—the basis for our recommendation.

Mr. **McGrath**. I understand the basis for your recommendation. All I am saying to you is that we have had a chance during the last year to revisit some of the provisions we enacted last year. In some cases last year, we found that where the Blues are the insurers of last resort and insure AIDS cases and insure other cases that some of the other commercial companies perhaps would not insure; that perhaps they are eligible, that Congress would deem them eligible to be designated as 501(c) organizations.

I am wondering if we make that determination on behalf of one Blue, or another Blue, or a series of Blues, whether or not that would change your rationalization for taxing these workers' compensation funds?

Ms. **Carlisle**. Again, Mr. McGrath, from a tax policy perspective, no. It would make us blue.

Mr. **McGrath**. It would make you blue?

Ms. **Carlisle**. Yes.

Mr. **McGrath**. I understand.

Thank you very much, Mr. Chairman.

Chairman **Rangel**. Mr. Levin, would you like to inquire?

Mr. **Levin**. With your permission, might I ask just a few quick questions.

Following up Mr. McGrath's question, and as you know, this has particular impact potentially in Michigan, what is the tax policy reason for treating a self-insured situation different than a pooled self-insured situation for workers' compensation?

Ms. **Carlisle**. The tax law provides——

Mr. **Levin**. No, no, not the tax law. Give me the tax policy reason. In terms of sound tax policy, why differentiate?

Ms. **Carlisle**. As I understand it, Mr. Levin, you are asking is there any difference, any policy difference between allowing a deduction for reserving my own individual account to pay for future liability claims, and allowing a deductible premium for welfare benefit associations, such as a VEBA?

Mr. **Levin**. No.

Ms. **Carlisle**. No

Mr. **Levin**. You are saying if one company is self-insured, it is one thing. If 50 companies self-insure, it is a different thing?

Ms. Carlisle. Right.

Mr. Levin. Now, why, from a tax policy purpose, public policy? Give me the reason.

Ms. Carlisle. Section 461(h) under the code allows for the deduction of a payment when economic performance in effect occurs.

If I shift a risk among 50 employers such that my liability and my premium is distributed among all of those, so that claims against the pool are not claims against my specific account, it is very similar to an insurance company, but not identical to an insurance company.

Mr. Levin. You are not giving me a policy reason. You are saying, well, it is like an insurance company. But you have a situation essentially where a hundred companies pool their insurance, and they give back what is not needed, keeping a sound reserve, but they do not return the monies until there is a State determination as to what is a sound reserve.

Now, what is the public policy reason for treating the situation differently where you have 50 companies pooling their risk, or where one company pools that risk?

Ms. Carlisle. When one company is holding that risk, I have not had an event which will trigger a deduction for tax purposes.

What you are saying, Mr. Levin, is that I, an individual corporation should be able to set up a deductible reserve for what I anticipate to be anticipated claims against me, the corporation. That is the individual case 461(h) under the code now provides that I, an individual corporation may not take a deduction for individual workers' compensation claims until such claims are actually paid to the claimant, not when they are set up in a reserve for me, but actually paid to the claimant.

Mr. Levin. We will have to explore this further. I do not want to take up too much time here.

A couple other questions. You say that it is right for judicial determination, but then you talk about suggested changes in the law. The whole purpose of the moratorium is to allow this subcommittee, is it not, to look at proposed changes in the law? And you yourself recommend changes in the law, right?

Ms. Carlisle. Yes, sir.

Mr. Levin. I do not understand why there should not be continuation of the moratorium until there is determination by Congress as to what is the appropriate law.

Ms. Carlisle. The issue that we have addressed and with respect to which we have asked the committee to consider changing the law would apply prospectively to years not in litigation, in audit, or in the audit process.

Mr. Levin. Those were changed in the law?

Ms. Carlisle. We have not asked for any change in the law vis-a-vis the issues that are currently under audit by the Internal Revenue Service.

Mr. Levin. You know there have been private letter rulings on this issue?

Ms. Carlisle. Yes, sir.

Mr. Levin. And under these letter rulings, the deduction has been permitted in the year of declaration. In other words, you are challenging a practice that has been allowed under private letter rulings, are you not?

Ms. CARLISLE. I believe there have been certain letter rulings. I am not quite sure of the cases in those, Mr. Levin.

I could say that a private letter ruling is not precedent. It is addressed to one taxpayer. In those particular rulings, I will certainly look into it for you, sir, but I do not believe that we are talking about a change in administrative policy.

Mr. LEVIN. You are not aware what these say specifically?

Ms. CARLISLE. I have read them sir, but I am not aware of the facts at the present time.

Mr. LEVIN. No further questions.

Thank you for this opportunity.

Chairman RANGEL. Yes?

Mr. MCGRATH. May I have one further question?

Chairman RANGEL. Yes.

Mr. MCGRATH. This is a problem with the total reserves the States require these workers' comp self-insured program to maintain.

Ms. CARLISLE. Yes, sir.

Mr. MCGRATH. Has there been that much of an abuse with overage of reserves that would require your kind of remedy?

Ms. CARLISLE. The remedy, Mr. McGrath, in the Service's view, is that the proper timing of the deduction for policyholder dividends is at the point in time when that deduction accrues for tax purposes.

Now, it is merely a timing issue. You are asking me is it a significant timing issue? The only thing I can do is refer back to Chairman Rangel's cite of an $18 million tax deficiency. That must mean that the timing of the deduction is relevant.

Now, with respect to Mr. Flippo's question, remember this is a timing issue as far as we are concerned. It is not an issue going to whether these are policyholder dividends and should be disallowed or allowed as a deduction in general.

Mr. FLIPPO. Mr. Chairman, may I have one followup question?

Chairman RANGEL. Mr. Flippo.

Mr. FLIPPO. Mr. Vander Jagt's bill would create a new section under 501(c) in which these self-insured funds would be designated tax free.

Do you believe this is—at the present time, the present tax reform law, in your interpretation, would treat these self-insurance funds as mutual companies?

Ms. CARLISLE. Yes, sir.

Mr. FLIPPO. And would be required to discount their reserves?

Ms. CARLISLE. Yes, sir.

Mr. FLIPPO. And would be required to pay a tax on some portion of that dividend?

Ms. CARLISLE. Yes, sir.

Mr. FLIPPO. Why do you feel that it is not proper then as Mr. Vander Jagt would suggest that the 501(c) is the way these companies have been treated for more than a decade.

Why do you not think that is not proper treatment for the future?

Ms. CARLISLE. Well, to repeat again, our level playing field argument with those commercial insurance companies, and also too the fact, going back to something again Chairman Rangel asked earlier, only approximately 25 of the States allow for workers' compensation associations, that is, allow groups of individuals to form one. So that there is again a level playing field argument among employers in different States. Employers in some States would be allowed to set up these tax exempt entities; employers in other States would not.

Mr. FLIPPO. You mean if all the States did it, you would not have any objection to it?

Ms. CARLISLE. That is one of the arguments, sir.

Mr. FLIPPO. Thank you. Thank you, Mr. Chairman.

Chairman RANGEL. Well, Ms. Carlisle, it would help if you did have staff review some of the allegations that the firms have made as relates to what could happen if they did not get relief.

Ms. CARLISLE. I promise we will make that analysis and make it available to you quickly.

Chairman RANGEL. That would be very helpful to this committee.

[Information follows:]

Question. What will happen if the self-insurance funds fail to get relief from all the "all-events" test for dividends?

Answer. In response to the Chairman's questions, I have asked the Treasury Office of Tax Analysis (OTA) to consider some of the economic implications of applying the "all events test" to policyholder dividends of workers' compensation self-insurance funds. I am happy to provide the following information which summarizes the results of OTA's findings. However, because the potential liabilities of the self-insurance funds attributable to any tax deficiencies arising in prior years have not yet been resolved by the Internal Revenue Service, OTA was unable to examine the impact of such liabilities on fund operations.

The primary economic function of the self-insurance funds is to pool employer premium contributions to pay workers' compensation claims by employees. The funds function like a mutual property and casualty insurance company which pays out, as dividends to insured employers, *all* fund assets not estimated to be required to compensate workers for job-related illnesses and accidents.

Analysis of the Impact of Prospective Application of the "All Events Test" for Policyholder Dividends of Self-Insurance Funds.—Policyholder dividends of property and casualty insurers are tax deductible under Section 832(c)(11). Self-insurance fund managers have typically made use of this provision by declaring policyholder dividends of sufficient magnitude to eliminate their potential Federal tax liabilities. The "all events test" would delay the deductions for policyholder dividends until the dividends had been approved by the responsible state regulatory agency.

If waiting for such approval delays the dividend deduction for some time, premiums will have to rise by enough to cover the interest costs on amounts borrowed to pay the taxes attributable to the nondeductibility of the declared dividends. Data provided in the April 7 testimony of Joseph Mastrovito, chief of the Bureau of Self Insurance of the State of Florida before the House Ways and Means Subcommittee on Select Revenue Measures, can be used to provide a rough estimate of the impact of the "all events test" on required premiums.

In his testimony, Mr. Mastrovito estimated total policyholder dividends paid by self-insurance funds in Florida for the most recent policy year for which data are available at $16.5 million. According to information provided to OTA by Mr. Mastrovito, total self-insurance premiums for the same period were approximately $224.9 million.

If, for simplicity, the tax rate on the self-insurance funds is assumed to be 34 percent (the top corporate tax rate in all years after 1987), and the funds can borrow at a before-tax cost of 10 percent, the after-tax cost of fund borrowing would be 6.6 percent. Mr. Mastrovito has told OTA that it typically takes about 1.75 years in Florida to obtain regulatory approval of declared policyholder dividends, so that perhaps a two year delay in deductibility might arise. Florida self-insurance funds might thus have to borrow $5,160,000, the tax liability on the $16,500,000 of taxable income attributable to the non-deductibility of dividends, in each of the first two years. The cost of borrowing a total of $11,220,000 at the after-tax rate of interest of 6.6 percent, approximately $741,000, would have to be reflected in higher premiums. There would be only minimal tax liability (attributable to growth) on the fund after the first two years due to the "all events test" because the deduction for the dividends declared two years earlier would offset nearly all of the taxes attributable to the current year's otherwise taxable income.

If the funds were prevented from borrowing by state regulations, their premiums for the first two years would have to rise by $5,160,000 to pay the tax liabilities on the policyholder dividends declared. As noted above, after the first two years, the funds' tax liabilities would be zero. To allocate the costs of delaying the deduction for dividends in roughly the same manner as in the case where loans were permitted, the fund managers would effectively have to increase premium charges by $5,160,000 for all future years but refund each year's extra premium of $5,160,000 two years later. For example, the extra charge to the 1989 customers could finance the refund to the 1987 customers. Although the employers would obtain a refund of the extra payments after two years, they would bear an annual cost of roughly $741,000 of lost income (assuming that they would otherwise be able to earn a 10 percent before-tax rate of return on the funds used to pay the extra premiums and would be subject to a 34 percent tax rate).

Thus it is estimated that annual 1987 premium (or opportunity) costs would rise by about 0.3 percent (−$741 thousand in increased premiums/$244.9 million of initial premiums). It is further estimated that the 0.3 percent increase in workers' compensation premiums (or lost income) for employers who self insure in Florida would translate to a labor cost increase for these employers of aproximately 0.005 percent. Assuming the Florida figures are representative of the rest of the nation, the prospective application of the "all events test" would be expected to have a minimal impact on labor markets.

Chairman RANGEL. In addition to that——

Ms. CARLISLE. May I ask the chairman, in the hearing as it proceeds this afternoon, to please ask the participants in the panels to make available to us such information.

Chairman RANGEL. I have reviewed their testimony and they are going to do that.

Ms. CARLISLE. Terrific.

Chairman RANGEL. Right.

In addition to that, you might also let the committee know what impact, if we have the Vander Jagt amendment passed into law, this would have on the commercial insurance companies. And some estimate as to what the revenue losses would be if, indeed, they were put out of business as a result of tax exempt self-insured workmen's compensation plans.

Ms. CARLISLE. Yes, sir.

[Information follows:]

Question. What is the estimated revenue effect of granting a tax-exemption to self-insurers and what impact would this have on commercial insurers?

Answer. In his testimony, Mr. Mastrovito (Chief of the Bureau of Self-Insurance of the State of Florida) indicates that the number of employers participating in Florida's self-insurance funds has increased by a factor of four since 1979 (6,000 employers in 1979 to 24,000 employers in 1986). The Tax Reform Act of 1986 made a number of changes that are likely to increase the marginal tax rates paid by commercial property and casualty insurance companies. With a cost advantage over commercial insurers due to tax exemption, self insurance funds could be expected to become increasingly more attractive to employers in the future due to the tax changes introduced in 1986. As more employers obtained their workers' compensation insurance through self-insurance, tax revenues from commercial insurance companies would decline. It is estimated that granting self-insurers a tax exemption would have a revenue cost over $0.5 billion in 1987–1991.

Chairman Rangel. Because you do believe that it would affect the competitive nature of the insurance companies if the Vander Jagt tax exemption would be law?

Ms. Carlisle. I think it would be an issue.

Now, are you saying whether commercial insurance companies would fold up and go away?

Chairman Rangel. Well, did you not say that you thought that by granting tax exemption to the self-insured plans that this would adversely affect the commercial insurance companies?

Ms. Carlisle. Yes, sir.

Chairman Rangel. Well, I would like to know the extent that you believe it would affect them.

Mr. Stark.

Mr. Stark. Thank you, Mr. Chairman.

Ms. Carlisle, I am sorry to have missed your presentation, but I am familiar with your testimony.

I guess I would keep looking to see if there is any reason on God's green earth to grant a tax exemption to these groups except for the fact they have been getting away with it for the past few years.

Has anybody presented any basis of equity or tax policy that would say you have been getting away with it, therefore we ought to let you continue to get away with it? Has anybody built any case other than that?

Ms. Carlisle. As people have said before, I am very glad you have an open mind, Mr. Stark.

The Treasury position is in accord with yours, Mr. Stark.

Mr. Stark. Were you able to present some of the deep concerns that the Treasury shares with me as to what kind of a precedent this might establish?

Ms. Carlisle. I do not think we went into that, but I would be happy to.

Mr. Stark. Would you find any difference, for instance, if this were to pass, would it not seem, as night follows day, that we might want to give the same kind of exemptions, say, to Blue Cross-Blue Shield?

Ms. Carlisle. I think Mr. McGrath referred to that earlier.

Mr. McGrath. Mr. Chairman, would my colleague yield?

Mr. Stark. I would be glad to yield to the distinguished gentleman from New York.

Mr. McGrath. Where were you when she needed you? [Laughter.]

Mr. Stark. You have got to save the world on several different fronts this year. It is a little bit like Russia. [Laughter.]

Well, Ms. Carlisle, I appreciate your testimony and, as usual, the skill with which you try and guard the public coffers from those who might like to dip into it from time to time, and I appreciate your testimony. And I look forward to the other witnesses' testimony.

Thanks a lot.

Ms. Carlisle. Thank you.

Chairman Rangel. Thank you, Ms. Carlisle, for your first visit with us, and we look forward to your return.

Ms. Carlisle. Thank you.

Chairman **Rangel**. The Chair would now call the Alabama Council of Self-Insured Funds, John Allen. He is the director of the Department of Industrial Relations for the State of Alabama, and you might want to welcome the distinguished gentleman and explain the 5-minute rule in your most eloquent way.

Mr. **Flippo**. I would be delighted to, Mr. Chairman.

We are very pleased to have the director of the Department of Industrial Relations for the State of Alabama, Mr. Allen. And, Mr. Allen, I believe you have your counsel with you today, if you would like to introduce him.

Pleased to have you. And the chairman has already indicated he will include your entire statement in the record and ask that you summarize within 5 minutes if that might be possible.

We appreciate your testimony, and glad to have you here, John.

Chairman **Rangel**. And, Mr. Allen, we have read the history of the Alabama law, and Mr. Flippo has taken time out to brief us as to how all of this came about so that we are familiar with the existing law, and you may proceed as you may want.

Mr. Allen, looking around, we have the Floridian, Joseph Mastrovito, chief, Bureau of Workers, Department of Labor and Employment Security, as well as the gentleman from the home State of Members, Congressman Vander Jagt and Mr. Levin, John Miron, chief deputy director of Bureau of Workers and Disability Compensation, the Michigan Department of Labor.

I assume that all of these plans are basically the same. They were enacted into law at different times, and they were modeled after each other. And we appreciate why they were formed in this way. And I think that would assist you so that you really get to the key questions that we are involved in. You might address yourself to the level playing field and the commercial insurance companies and the issues that were raised by Treasury and Mr. Stark.

Mr. McGrath.

Mr. **McGrath**. Mr. Chairman, looking over the witnesses here and knowing that we are members of this subcommittee, we both come from New York, why do we not have any witnesses from New York?

Chairman **Rangel**. There was no request from New Yorkers.

Mr. Allen, you may proceed.

STATEMENT OF JOHN G. ALLEN, DIRECTOR, ALABAMA DEPARTMENT OF INDUSTRIAL RELATIONS, FOR ALABAMA COUNCIL OF SELF-INSURANCE FUNDS, ACCOMPANIED BY MARK DAVIS, ADMINISTRATOR, ALABAMA WORKMEN'S COMPENSATION DIVISION

Mr. **Allen**. Well, Mr. Chairman and members of your open-minded subcommittee, I am John Allen, director, Alabama State Department of Industrial Relations. I was appointed to this cabinet position by Governor Hunt in January of 1987.

I have with me today Mr. Mark Davis, administrator of Alabama's Workmen's Compensation Division. His role will be to answer any technical questions that I am not qualified to answer. And that could be many.

I appreciate your statement on brevity and inasmuch as you have prompted me to be even more brief than I intended to be, I will do just that. So I will not read the statement in its entirety that I have. And I think probably what I shall do is to go over to the conclusions and give you our conclusion and hold it to about 2 minutes.

Since the Internal Revenue Service has been recognizing these funds as mutual insurance companies, and due to the strict regulatory requirements established by the department, I submit that the contemplated changes by the Internal Revenue Service would result in total chaos for the funds now in existence in the State of Alabama.

Should these funds be required to file as stock companies, they would have no choice but to discontinue the funds. Furthermore, under the required indemnity agreement, it is conceivable that many companies would be forced into bankruptcy to satisfy existing and outstanding claims and litigation. In addition, there would be an immediate and drastic increase in unemployment of employees covered by these funds in the State of Alabama.

It is our estimation that some 1,100 companies would be affected immediately, representing approximately 50,000 employees in our State. They could be unemployed.

As to the dividend question raised by the Internal Revenue Service, it is our opinion that such question does not apply to funds operating in the State of Alabama. Under the department regulations, any surplus moneys at the close of a fund year in excess of the amount necessary to fulfill all obligations under law, may be distributed to its members at the discretion of the trustees after the close of the second year, and after notice to the director of the proposed distribution, unless the director determines that such discretion would impair the solvency of the claims funds. Any surplus contributions received by companies under these regulations would naturally be required to pay tax on those moneys.

For the above reasons, we urge you to approve H.R. 1489, which would establish a new exempt status under section 501(c) of chapter 1 of the Internal Revenue Code. This action would clarify once and for all the responsibilities of such approved self-insured funds as authorized by State law.

Mr. Chairman, this concludes my formal statement. I might just ad lib a couple of things from a practical side and a layman's side inasmuch as I came out of private industry less than 2 or 3 months ago and am familiar from that viewpoint.

As past president of our State industrial association, I might add that 85 percent of our membership in the State industrial association is from companies with less than 530 employees. So really a small business is big business in our State and, I am sure, throughout our nation. And many people stay in business because they have this kind of break. It really gives them a 35 to 50 percent reduction in rates that they could go out and receive on the stock market. And in today's competitive world, with foreign competition and some of the things that we are faced with, this makes a difference for many of our small companies in our State to stay in business.

So it is just for this reason I have my most major concern on this subject.

Thank you very much, and we will be happy to try and answer any questions that you might have.

[The prepared statement follows:]

TESTIMONY OF
JOHN G. ALLEN
DIRECTOR
ALABAMA DEPARTMENT OF INDUSTRIAL RELATIONS
before the
COMMITTE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES
UNITED STATES HOUSE OF REPRESENTATIVES
with regard to
H.R. 1489 - "SELF-INSURED WORKER'S COMPENSATION FUNDS TAX EXEMPT STATUS CLARIFICATION ACT OF 1987"
Washington, D.C.
April 7, 1987

Mr. Chairman and Members of the Subcommittee:

I. INTRODUCTION

I am John Allen, Director, Alabama State Department of Industrial Relations. I was appointed to this cabinet position by Governor Guy Hunt on January 16, 1987.

I appreciate the opportunity to present the Department's views on self-insured worker's compensation funds now existing in Alabama as authorized under Alabama law and how the passage of H.R. 1489 would be advantageous to these funds.

My comments will address the history of self-insured worker's compensation fund in Alabama, and the two problems posed by the Internal Revenue Service concerning these funds.

II. HISTORY OF SELF-INSURED WORKER'S COMPENSATION FUNDS IN ALABAMA

A. STATUTORY

1. In 1965, a bill was passed by the Alabama Legislature permitting group self-insurers to pool their liabilities for the purpose of qualifying as self-insured under Chapter 25, Code of Alabama. The bill was signed by the Governor and became Act. No. 407, 1965.

2. The Act charged the Director of the State Industrial Relations Department to promulgate such rules as he deemed advisable for proper compliance with the law, as intended by the Lesiglature.

B. REGULATORY

1. In order to be approved as a self-insured fund, the following requirements must be met:

   a. The group of employers must be engaged in the same or similar type business or be a member or an associate member of the same trade association.
   b. The members of a group making application to be self-insured must elect a board of trustees, who are members of the fund.
   c. An indemnity agreement jointly and severally binding the self-insured fund and each member thereof to comply with the provision of the Alabama Workmen's Compensation Law and the Rules of the Department of Industrial Relations.
   d. A set of by-laws which shall govern the operation of the self-insured fund.
   e. All self-insured funds are required to maintain specific excess insurance with a limit of at least $1,000,000.
   f. The trustees shall contract with an approved service organization to service its members with respect to underwriting matters, claims adjusting and may offer industrial safety engineering as an extra service to the members of the fund.

After having approval from the Director to establish a self-insured fund, the trustees must also comply with the following:

A. The trustees shall deposit with the Director acceptable securities, or post with the Director an acceptable surety bond issued by a corporate surety company, a minimum of $50,000 and may be higher depending on the type of industry and its financial stability.

B. The trustees must secure a contract for excess insurance issued by a recognized, admitted or approved insurance company for an amount of not less than $1,000,000.

C. The trustees shall designate a service agent and/or administrator to administer the financial affairs of the fund, who shall be bonded to the trustees in an amount sufficient to protect the fund against misappropriation or misuse of any monies or securities.

D. Each fund must be audited annually by a certified public accountant.

E. The trustees shall file with the Department condensed quarterly status reports of each claim fund within twenty (20) days after the close of the reporting period, such reports to show the total receipts and disbursements (separating medical and compensation payments) during the quarterly period, and total fund balance and total amounts set aside as reserves for payment of losses incurred, but not paid, as of the close of the reporting period.

F. The trustees or their service agents or administrators shall not utilize any of the monies collected as premiums for any purpose unrelated to workmen's compensation insurance or workmen's compensation insurance matters. Further, they shall be prohibited from borrowing any monies from the fund or in the name of the fund without advising the Department of the nature and purpose of the loan and obtaining Department approval.

G. The trustees may, at their discretion, invest any surplus monies not needed for current obligations and direct obligations of the United States Treasury, such as notes, bonds or bills which are backed by the full faith and credit of the United States Government or its agencies.

H. The Director may revoke or terminate any self-insured fund for failure to comply with the rules of the Department.

III. PRESENT STATUS OF FUNDS

A. There are ten (10) active self-insured funds operating with the approval of the Director. Four thousand, four hundred and three (4,403) employers are members of these funds, having an approximate total of one hundred fifty four thousand (154,000) employees covered as of February 28, 1987. Approximate annual contributions to these funds amount to thirty two million dollars ($32,000,000).

B. Insurance companies incorporated in Alabama and those doing business in Alabama, are not required to pay state income tax, but are required to pay a premium tax to the State Insurance Department. Self-insured funds established by law are not required to pay state income tax or to pay any premium tax.

C. Self-insured funds in Alabama have been filing federal tax returns as mutual insurance companies since their inception, and due to their very nature, it is the concensus of the Department that this is the correct method for such filings.

IV. CONCLUSIONS

A. Since the Internal Revenue Service has been recognizing these funds as mutual insurance companies, and due to the strict regulatory requirements established by the Department, I submit that the contemplated changes by the Internal Revenue Service would result in total chaos for the funds now in existence in Alabama.

Should these funds be required to file as stock companies, they would have no choice but to discontinue the funds. Furthermore, under the required indemnity agreement, it is conceivable that many companies would be forced into bankruptcy to satisfy existing and outstanding claims and litigation. In addition, there would be an immediate and drastic increase in unemployment of employees covered by these funds in Alabama.

B. As to the dividend question raised by the Internal Revenue Service, it is our opinion that such question does not apply to funds operating in Alabama. Under the Department regulations, any surplus monies at the close of a fund year in excess of the amount necessary to fulfull all obligations under law, may be distributed to its members at the discretion of the trustees after the close of the second year, and after notice to the Director of the proposed distribution, unless the Director determines that such discretion would impair the solvency of the claims fund. Any surplus contributions received by companies under these regulations would naturally be required to pay tax on those monies.

C. For the above reasons, we urge you to approve H.R. 1489, which would establish a new exempt status under Section 501(C) of Chapter 1 of the Internal Revenue Code. This action would clarify once and for all the responsibilities of such approved self-insured funds as authorized by state law.

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Chairman RANGEL. Thank you.

Mr. Mastrovito.

STATEMENT OF JOSEPH MASTROVITO, CHIEF, BUREAU OF SELF-INSURANCE, DIVISION OF WORKERS' COMPENSATION, FLORIDA DEPARTMENT OF LABOR AND EMPLOYMENT SECURITY

Mr. MASTROVITO. Thank you.

I have the responsibility in the Florida Department of Labor and Employment Security for regulating the workers' comp self-insurance funds in the State of Florida.

We currently have 18 funds in the State of Florida, and these funds represent over 24,000 Florida employers and about a million Florida employees receive their workers' compensation benefits from workers' compensation funds.

Our rules and law are very similar to Michigan's, and I think that the facts in the cases in Michigan would fit the Florida fund, and if tax liabilities were assessed in Michigan, they could be assessed in Florida.

My concern as a regulator is that these dividends are really to be used for important regulatory purposes in the sense that they provide money for additional reserves. And that is why we regulate the payment of dividends and determine it that only after reserves are met that dividends be paid.

The position of the IRS really would hamper our regulations greatly. Obviously if the moneys were paid to obtain the dividend deductibility, they would not be available for the use in reserves. If the moneys were held for reserves, they would be taxed. Of course, we are also concerned about the assessment of the tax liabilities on existing funds, the accessibility of the employer members to pay for shortfalls in the funds held by these programs could be called into question if the reserves were seized to satisfy tax liabilities.

These funds have no surplus except for dividends, and they have little assets other than reserves for claims. And so tax liabilities would be satisfied through taking assets that were destined for benefits to injured workers.

As I said, these funds are not insurance companies, and they are not regulated as insurance companies in the State of Florida. They are regulated by the work comp agency. They do not build up surplus. There is no requirement for—there would be premium to surplus relationship as there are in insurance companies.

To answer a question that was posed earlier, I made an estimate of what kind of tax liability may be out there for the funds in Florida. My estimate is approximately $10.6 million for the 1982 through 1985 years, and about $7.6 million in the 1986 year. And my concern is would the revenue of about $18 million to the Federal Treasury be worth causing what would be chaos in our workers' compensation system affecting substantially 24,000 employers and their solvency, and affecting potential benefits to a million workers.

Now, we have found that these funds serve a public purpose in Florida. They provide a marketplace for workers' compensation coverage for employers. They have been around when the insurance industry has been reluctant to write these types of coverages.

And I feel that they need to be protected from insolvency by assessment each tax liabilities.

I would also point out the Congress has enacted in the Risk Retention Act risk sharing mechanisms which apply to general types of liability coverages. And these funds serve the same purpose for workers' compensation coverage. And I think that, as the regulator in the State of Florida, I would ask that you consider some remedy which would protect these funds from insolvency from a substantial tax liabilities and to give favorable consideration to the treatment of our handling of dividends for the protection of solvency of these programs.

Those are my remarks. Thank you.

[The prepared statement follows:]

Written testimony of
Joseph Mastrovito
Chief, Bureau of Self-Insurance
State of Florida
Department of Labor and Employment Security
Division of Workers' Compensation

I am employed by the Florida Department of Labor and Employment Security in the Division of Workers' Compensation. My specific duty is as Chief of the Bureau of Self-Insurance. This Bureau has the responsibility for regulating the self-insured employers and group self-insurance programs in Florida. I have had these responsibilities since 1979. Overall, I have had 14 years experience in workers' compensation self-insurance while employed by the State of Florida.

Florida has had self-insured employers since the passage of the initial Workers' Compensation Act in 1935. Group self-insurance was authorized in 1937. The regulation of self-insurers has always been within the workers' compensation agency in Florida.

I have become aware of an issue involving group self-insurance programs in Michigan and the Internal Revenue Service. This issue, involving the tax filing status of group self-insurers and the determination of taxable income, had a direct impact on the group self-insurers which I am responsible for regulating in Florida. I have asked to be able to testify before this sub-committee so that I can advise the sub-committee of the potential impact of the events in Michigan on group self-insurance in Florida.

Before I begin my comments on the tax issues, I would first like to give some background information on the group self-insurance programs in Florida. In our regulations we use the term "self-insurers fund" or "fund" to refer to a group self-insurance program. I will use these two terms interchangeably.

The Florida law governing self-insurers funds is contained in Section 440.57, Florida Statutes. The regulations governing funds in Florida are contained in Rule Chapter 38F-5, Florida Administrative Code. Self-insurers funds must make application to the Division of Workers' Compensation and be licensed before they may begin operations in Florida.

Under Florida law and rules, a fund is an unincorporated association of employers with a common interest. Common interest is defined as all employers being a member of the same bona fide trade association or all employers being in the same or similar business. The fundamental document creating a self-insurers fund is the indemnity agreement. This document, whose contents are established by rule, requires that all employers participating in a fund are jointly and severally liable for the losses of the group. Thus, all members guarantee the payment of workers' compensation benefits to their own employees and to all employees of every other member, to the full extent of the assets of each business.

Each fund is governed by a board of trustees who have complete financial control of the assets of the fund and who are charged with safeguarding the assets of the fund, within the guidelines specified within the regulations. The trustees are required to adopt by-laws or enter into a trust agreement. These by-laws or agreements establish the purpose of the fund which is to provide workers' compensation coverage to their member employers at cost.

The fund collects a premium from each member. The funds may use this premium for only four purposes: the payment of legitimate operating expenses, the payment of claims, establishing reserves for future claims payments and for paying dividends to members. Premium may not be expended for any purpose contrary to the workers' compensation law or to the regulations.

Self-insurers funds are tightly regulated by the Division of Workers' Compensation and the Bureau of Self-Insurance. Funds are required to submit annual audited financial statements as well as a financial report prepared on a regulatory basis. Funds submit quarterly experience reports which summarize the amount of premiums collected, number of claims incurred, number of open claims, amount of claims paid and reserves established.

Each fund has a specific policy year. That is, all members' policies renew on a common date. This is done for a very important reason. Each policy is treated as a separate and distinct fiscal period and the regulations require that in each policy year, the sum of the premium collected plus investment earnings must be greater than or equal to the amount of operating expenses plus the cost of claims and claims reserves.

In order to accomplish this, the fund purchases insurance coverage, known as excess insurance, to reimburse the fund for losses greater than the amount of premium available for payment of losses. In this way, the fund is protected from insolvency because a year with high losses cannot affect another year.

In a given policy year, if the amount of claims plus reserves is less than the premium collected plus investment earnings, the trustees will request permission of the State to pay the excess premium collected and excess earnings to the members as a dividend. Prior approval of the State is required. Before permission is granted, a review is made of the fund's financial condition and an actuarial analysis is made of the fund's losses and reserves. Only after the fund's total ultimate reserves are fully funded will a dividend be approved.

If a fund should have a policy year in which there was insufficient premium income available for payment of claims or funding reserves, then the members during that policy year would be assessed an additional premium sufficient to cover the total amount of the deficiency. When this has occurred in the past, the principle cause has been the uncollectability of proceeds from excess insurance policies.

There are many specific operational restrictions placed on these funds. The type of investments available are limited to bank instruments, United States Government or United States Government Agency securities and State of Florida securities. No speculation is allowed when purchasing securities; securities must be purchased with the intention of holding them to maturity. The State specifies the type and amount of excess insurance coverage which the fund will purchase. The State determines the adequacy of the fund's loss reserves.

However, the funds are not required to accumulate surplus in the way insurance companies are required to. There is no premium to surplus ratio which funds are required to maintain. The only surplus that appears on a fund financial statement is dividends not yet paid to members. This occurs because funds may not pay a dividend of excess premium for at least 12 months after the end of a given policy year. This waiting period is mandated to allow the claims reserves to stabilize before a decision is made on determining the amount of excess premium that is available for a dividend after establishing the necessary reserves.

There are currently 18 licensed self-insurers funds in Florida. The oldest has been in continuous operation for 35 years. Several others have been in operation for over twenty years. Membership in funds has increased from less than 6,000 employers in 1979 to over 24,000 employers in 1986. The employers who join these funds are primarily small employers who pay an average of $11,600 per year in premiums to the funds.

These 24,000 employers represent almost 10% of all employers in the workers' compensation system in Florida. I estimate that over 20% of all employees covered by workers' compensation in Florida receive their benefits from self-insurers funds. That amounts to about 1,000,000 employees.

Fund membership continues to grow at the same rate as it has in the past. Funds have been a stable source of workers' compensation coverage through the periods when the insurance industry has been reluctant to write this type of coverage for small businesses. The presence of funds in Florida has fostered competition which has resulted in lower costs for workers' compensation coverage for Florida employers.

The summary of Florida's law and regulations for self-insurers funds applies almost completely to the regulatory situation in Michigan. My predecessor as chief regulator of self-insurance in Florida assisted the State of Michigan in setting up their group self-insurance program. Michigan adopted almost entirely the regulations in place in Florida. The facts developed in the Detriot Tooling Association case would apply as well to all Florida funds.

With this in mind, I would like to address the issues as I understand them, that relate to the taxation of unpaid dividends of the Detriot Tooling Association case. The Internal Revenue Service has alleged that the dividends to members of the Detriot Tooling Association were not deductible from taxable income for the year in which the dividends were paid. This was mainly for two reasons: 1) the trustees could not make a binding declaration of dividend because the State must approve the dividend, and 2) the dividends were not paid immediately but after the State mandated waiting period had run.

As I stated before, these facts fit every dividend paid by every fund in the State of Florida. This position by the Internal Revenue Service spells disaster for self-insurers funds in Florida. First, because the Internal Revenue Service, if their position in the Detroit Tooling Association case is not overturned, will be free to assess huge tax liabilities on funds in Florida. For a fund, assets are almost entirely claims reserves. Thus to satisfy any substantial tax liability, the Internal Revenue Service will be forced to seize monies intended to provide workers' compensation benefit payments to injured workers.

In turn, the fund will have no choice but to assess each member for an amount sufficient to replenish the needed claims reserves. During the time this assessment is made and new monies are received, benefit payments will be disrupted or suspended entirely. The fund will be forced to ensure the payment of the assessment by its members even if such enforcement results in the bankruptcy of the member.

Remember, in the Detriot Tooling Association case the additional tax liability, including substantial penalties and interest, amounted to about $18,000,000. This was for a fund whose annual collected premium was about $18,000,000. There is no reason to believe that these numbers would not be repeated for the funds in Florida.

The second ingredient for disaster is that the position of the Internal Revenue Service destroys the State of Florida's ability to effectively regulate self-insurers funds. Control over the amount and timing of dividend payments is the cornerstone of our ability to ensure the adequacy of the reserves for the funds. Premature payment of a dividend or payment of too large a dividend can spell disaster for a fund.

The Internal Revenue Service position in the Detriot Tooling Association case forces an impossible situation on the fund and the regulator. If the dividend is held long enough for a proper determination to be made on the amount of reserves which are necessary, then the potential dividend will be taxed regardless of whether the dividends will ultimately be needed for reserves. If the dividend is paid immediately, then there will be no monies for additional reserves.

These funds do not build up surplus for adverse situations such as insurance companies are required to do. There is little margin for error in reserving. The potential dividends represent the only source of monies for additional reserves when the inevitable adverse loss development occurs. These potential dividends are used for only two purposes. They provide a source of money for reserves or they are returned to the member. The fund nor the trustees benefit from the unpaid dividends.

Also, dividends, when received by the member, are taxable as an offset to previously deducted expenses. The self-insurers funds are not a tax shelter.

I have reviewed the financial information that the funds have submitted to my office. I have also reviewed my files and tabulated the dividends which have been approved during the last three years. I wish to share my findings with you.

For the 1982/83, 1983/84 and 1984/85 policy years, dividends in the amount of approximately $23,000,000 were approved and paid by funds in Florida. This amount was 6.8% of the collected premium for the three policy years in question. Assuming that no dividend would be deductible from taxable income, the additional tax due at a rate of 46% would be about 10.6 million dollars. This, of course, does not include penalties and interest.

I have estimated the potential dividends available for the 1985/86 policy period based on an analysis of the fund financial reports and the actuarial estimates of necessary reserves. I estimate that 3.2% of the 1985/86 premium will be unneeded for reserves and will be payable as a dividend. In addition, there is an amount equal to 3.5% of premium in investment earnings which may be paid as a dividend. It should be noted that some investment earnings were used to pay necessary expenses. Therefore, an amount equal to 6.7% of premium should be available as a dividend, based on current data. This amounts to about $16,500,000.

Again, assuming that none of the $16.5 million would be deductible from taxable income, then this amount would produce an additional tax of $7.6 million, assuming a 46% rate. Again, this figure does not include penalties or interest.

I wish to pose the following questions to the sub-committee:

> Is the additional $10.6 million in revenue to the treasury for the 1982-84 years and the $7.6 million in revenues for the 1985/86 year worth causing chaos in Florida's workers' compensation system? Is the additional revenue worth bankrupting 18 self-insurers funds? Is the additional revenue worth causing financial distress or even bankruptcy to 24,000 Florida small employers? Is the additional revenue worth putting the workers' compensation benefits of 1,000,000 Florida workers in jeopardy?

The Congress has recognized the crisis that small businesses have faced due to the turmoil in the property-casualty insurance industry. The unavailability of insurance coverages and the skyrocketing costs have been well documented in the past. Congressional action in the form of the recent amendments to the Risk Retention Act provides a risk sharing mechanism for small employers with similar interests. This act, however, excluded workers' compensation from the types of coverages that could be offered. Self-insurers funds offer precisely the same type of cost-effective risk sharing mechanism in workers' compensation that is available through the Risk Retention Act for other types of property-casualty exposures.

I believe that it is in the public interest to preserve these funds as a mechanism for covering workers' compensation liabilities for small employers in a cost-effective manner. I believe that it is in the public interest to re-examine the tax status of these self-insurers funds in order to give state regulators the ability to properly protect the solvency of these programs.

These funds are not insurance companies. They are formed for the purpose of providing workers' compensation coverage at cost to their members. They have no stockholders. They do not accumulate wealth for their own use. They do not accumulate surplus for protection against adverse circumstances. They operate on a smaller margin of safety than insurance companies. To tax them as insurance companies severely effects our ability as regulators to require that the funds maintain the proper reserves.

Another issue which I will mention in passing is that my analysis of the changes in the Tax Reform Act of 1986 regarding insurance companies will further degrade our ability to regulate these funds. Discounting reserves is dangerous for a fund which has no accumulated surplus for use as a safety margin. Taxing 20% of unearned premiums restricts a fund's ability to collect premium in advance to reduce losses for bad debt. The alternative minimum tax further reduces monies available for reserves. These are additional factors which indicate that funds should not be taxed as insurance companies.

In conclusion, I believe that you should give favorable consideration to granting relief to self-insurers funds from potential adverse tax liability. I believe that these funds deserve special consideration in the way they pay dividends. I believe that creating a large additional tax liability for funds in Florida and elsewhere causes far more harm than the potential additional revenue for the federal treasury.

Chairman RANGEL. Thank you.
Mr. Miron.

STATEMENT JOHN MIRON, CHIEF DEPUTY DIRECTOR, BUREAU OF WORKERS' DISABILITY COMPENSATION, MICHIGAN DEPARTMENT OF LABOR

Mr. MIRON. Thank you, Mr. Chairman, members of the committee.

I have been professionally involved in workers' compensation in Michigan for almost 30 years. I am a past president of the International Association of Industrial Accident Boards and Commissions, which is the association of workers' comp administrators. In that capacity, I helped develop the group self-insurance rules, the model rules for that group, and they are being followed by many of the States who are just at this time adopting a group self-insurance program.

My purpose here today is to describe how group self-insurance operates in Michigan and, in that respect, it is my belief that this form of security for workers' compensation liability has had four primary benefits in Michigan.

It has made workers' compensation coverage available at reasonable cost for many small businesses.

It has increased the number of covered employers by making insurance coverage available to employers who might otherwise be forced to operate without insurance coverage because of its high cost.

The savings in this area have allowed Michigan businesses to have more money available for economic expansion and job creation.

In addition to that, it has provided a very strong incentive for safety, and it encourages rehab and reemployment of injured workers. This works both for the employer and the employee.

We feel that it is important in Michigan. Its continued availability would be upset if this bill was not passed. So I would like to give you some background which should clarify how it would impact on group self-insurance in Michigan.

In our State, every employer that has one full-time employee or three or more part-time employees is subject to the act. The requirement that virtually all employers have insurance coverage has benefitted injured employees by making compensation benefits available for work-related injuries. However, that requirement has also placed a burden on smaller employers who, by the nature of their size, are frequently excluded from the voluntary insurance market and forced to obtain insurance coverage at higher rates through the assigned risk program.

All employers are required to insure their operation through the purchase of insurance or by getting approval to be self-insured. Since 1974, Michigan law allows private-sector employers of the same industry and public sector employers of the same type of unit to form a fund. These group funds have been instrumental in reducing the cost of workers' comp coverage. Some of these funds were created by employers who, because of the nature of their size, were forced to obtain coverage through the assigned risk program where the rates were much higher than the voluntary market. Participation in this concept has enabled them to save considerable cost over the premiums that they would have paid through the assigned risk program.

The funds are stringently regulated by the bureau of workers' comp to ensure that they are financially stable. The bureau approves the rates that a group fund charges its membership, how those funds are invested after collected, and the amount of excess insurance and bonds that are obtained as security for the program by the fund.

The bureau is involved in review of the bylaws of each group fund and retains final approval over any changes in the bylaws that control the operating procedures of each fund. The bureau determines how financial information is reported and the frequency of such reports. The bureau's goal in regulation is to see that sufficient moneys are always available in each group fund to meet future obligations.

Our bureau approves the amount and timing of the refund of any surplus. Fund trustees make the initial decision on the amount of moneys that can be refunded to the membership after provisions are made for past expenditures, reserves for known cases, reserves for incurred but not reported claims, and reserves for future increases on known cases.

In most instances, the bureau will send a staff person to conduct an audit of each group fund's case file before we act on the refund request. The purpose of the audit is to determine the adequacy of the reserves on the claims files at that time.

The rules and regulations provide for the return to the employer members of all funds collected as premium in the past which are not needed to satisfy current obligations or cover reserves for future losses. We believe that all of the funds that we require the group fund to retain may be necessary to cover the future cost of claims.

Group fund members are jointly and severally liable for the fund's obligations. Group funds are required to maintain excess insurance which reimburses group funds if losses run above certain levels. The adjusting of claims, setting of reserves, and payment of benefits are handled on behalf of the group funds by a service company which is approved by the bureau upon showing that they have adequate facilities and competent staff to administer the funds.

We currently have 37 group funds which represent over 7,000 employers in the State.

Group self-insurance for workers' comp plays a critical role in the availability of insurance coverage at an affordable cost. To survive, such self-insurance plans must operate on a nonprofit basis since all of the moneys that are not used to pay claims or administrative expenses of the group fund are ultimately returned to the membership as a dividend. Group self-insurance has allowed many employers to reduce their cost for this statutorily mandated coverage, and guarantee payment of benefits to injured employees who otherwise might be left without weekly benefits, medical care, and forced to depend on the welfare system for survival.

If the IRS prevails in its position that self-insurance funds are taxable, it is safe to assume that these funds will either cease in Michigan or be so severely hampered that they would no longer be able to maintain a viable and competitive place in the market.

These highly regulated self-insurance plans have carried out Governor Blanchard's strongly worded public policy of lowering workers' compensation costs and providing benefits for incurred claims.

Thank you.

[The prepared statement follows:]

Before the
Subcommittee on Select Revenue Measures
House Committee on Ways and Means

April 7, 1987

My name is John Miron. I am the Chief Deputy Director of the Bureau of Workers' Disability Compensation, Michigan Department of Labor. I have been professionally involved in the Michigan workers' compensation program for almost 30 years. I am a past president of the International Association of Industrial Accident Boards and Commissions (IAIABC). In this capacity, I helped develop the IAIABC Model Rules on Group Self-Insurance which were based on Michigan's group self-insurance rules.

I am here today to testify on House Bill 1489 which would clarify the tax-exempt treatment of group self-insured workers' compensation funds. My purpose here today is to describe how group self-insurance operates in Michigan and to answer any technical questions that you may have concerning this area of the Michigan workers compensation law.

It is our belief that this form of security for workers' compensation liability has had four primary benefits in Michigan.

-- It has made workers' compensation coverage available at reasonable cost for many small businesses.

-- It has increased the number of covered employers by making insurance coverage available to employers who might otherwise be forced to operate without insurance coverage because of its high cost.

-- The savings in this area have allowed Michigan businesses to have more money available for economic expansion and job creation.

-- Membership in a group fund creates a very strong incentive for the employer to contain costs by improving worksite safety and encouraging the rehabilitation and re-employment of injured workers.

Group self-insurance in Michigan is important. Its continued availability would be upset if HB 1489 was not passed. I would like to give you some background which should clarify how HB 1489 would impact group self-insurance in Michigan.

Workers' compensation coverage in Michigan is required for any employer that has one full time employee or three or more part-time employees. The requirement that virtually all employers have insurance coverage has benefited injured employees by making compensation benefits available for work related injuries. However, that requirement has also placed a burden on smaller employers, who by the nature of their size are frequently excluded from the voluntary insurance market and forced to obtain insurance coverage at higher rates through the assigned risk program.

All employers are required to insure their operation through the purchase of insurance or by getting approval to be self-insured. Since 1974 Michigan law allows private sector employers from the "same industry" or public sector employers from the "same type of unit" to form group self-insurance funds as an alternative to purchasing coverage from a commercial insurance company. These group self-insurance funds have been instrumental in reducing the cost of workers' compensation coverage. Some of these funds were created by employers who because of the nature of their size were forced to obtain coverage through the assigned risk program where the rates were much higher than the voluntary market. Participation in the group self-insurance concept has enabled them to save considerable cost over the premiums that they would have paid through the assigned risk program.

Group self-insurance funds are stringently regulated by the Bureau of Workers' Disability Compensation to insure that they are financially stable. The Bureau approves the rates that a group fund charges its membership, how those funds are invested after collected, and the amount of excess insurance and bonds that are obtained as security for the program by the group fund. The Bureau is involved in review of the by-laws of each group fund and retains final approval over any changes in the by-laws that control the operating procedures of each group fund. The Bureau determines how financial information is reported and the frequency of such reports. The Bureau's goal in regulation is to see that sufficient monies are always available in each group fund to meet future obligations.

Our Bureau approves the amount and timing of the refund of any surplus. Fund trustees make the initial decision on the amount of monies that can be refunded to the membership after provisions are made for past expenditures, reserves for known cases, reserves for incurred but not reported claims, and reserves for future increases on known cases. In most instances the bureau will send a staff person to conduct an audit of each group funds case files before we act on the refund request. The purpose of the audit is to determine the adequacy of the reserves on the claims files at that time.

Our administrative rules and regulations provide for the return to the employer members of all funds collected as premium in the past which are not needed to satisfy current obligations or cover reserves for future losses. The Bureau has final approval on any monies returned by the group fund to its membership. The funds remaining after specific reserves have been set may represent surplus, IBNR reserve, and additional reserves that may be necessary for known cases. We believe that all of the funds that we require the group fund to retain may be necessary to cover the future cost of claims.

Group fund members are jointly and severally liable for the funds obligations. Group funds are required to maintain excess insurance which reimburses the group fund if losses run above certain levels. The adjusting of claims, setting of reserves, and payment of benefits are handled on behalf of the group funds by a service company which is approved by the Bureau upon showing that they have adequate facilities and competent staff within the state to administer self-insurance programs.

There are currently 37 group funds in Michigan, which represent over 7,000 employer members.

Group self-insurance for Workers' Compensation plays a critical role in the availability of insurance coverage at an affordable cost. To survive, such self-insurance plans must operate on a non-profit basis since all of the monies that are not used to pay claims or administrative expenses of the group fund are ultimately returned to the membership as a dividend. Group self-insurance has allowed many employers to reduce their cost for this statutorily mandated coverage and guarantee payment of benefits to injured employees who otherwise might be left without weekly benefits, medical care, and forced to depend on the welfare system for survival. If the IRS prevails in its position that self-insurance funds are taxable, it is safe to assume that these funds will either cease to exist in Michigan or be so severely hampered that they would no longer be able to maintain a viable and competitive place in the market. These highly regulated self-insurance plans have carried out a strongly worded public policy of lowering workers' compensation costs and providing payments for incurred claims.

Mr. Chairman, members of the committee, at this time I would be glad to answer any questions that you may have regarding the concept of group self-insurance and how it is regulated by our state agency.

Chairman RANGEL. Thank you.

Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman, I appreciate that.

Does any of your funds experience deficits that may have to be allocated? Have you experienced any during your tours?

Mr. ALLEN. Our funds have not had any deficits to my knowledge throughout the history.

Mr. FLIPPO. How about you?

Mr. MIRON. We look at each fund year by itself so that there has not been a deficit of the overall fund. We have had an instance or two where there has—we have refunded money back too quickly. And there has been a deficit in that fund year.

Mr. FLIPPO. I believe we had some testimony that these funds were established, because of the reluctance of insurance companies to provide this coverage.

Would you elaborate on that? I believe you made that statement.

Mr. MASTROVITO. Well, sir, we have seen in Florida the effects of the insurance underwriting cycles where the companies will be over different periods of time reluctant to write certain types of exposures to certain classes of business or certain geographic localities.

And I think if you looked at our growth in self-insurance funds in Florida, you can see that periods of the high growth in funds has corresponded to the periods where the insurance industry has made their feelings known about the marketplace and their willingness to write.

Mr. FLIPPO. I would like to ask each of the panel members this. You feel you are not a mutual company generally and that you should not be—are you saying that you are not a mutual and should not be taxed like a mutual, or are you saying that the public purpose of tax exemption overrides that?

Mr. MASTROVITO. If I may answer that first, I believe that in Florida most, if not all, funds relying on their interpretation of the Tax Code and private letter rulings have been filing as mutual insurance companies as the correct method under the current law.

I believe that they have also relied on the deductibility of the declared dividends pending the approval of the regulators' permission to actually make the distributions.

My concern is the nondeductibility of dividends will take away a major regulatory tool we have to insure the solvency of these programs. And, of course, the assessment of retroactive tax liability could bankrupt these programs and cause some very severe chaos.

Mr. FLIPPO. Would any of the other panels care to react to that.

Mr. MIRON. I do not think that I am competent to determine whether it is a mutual insurance carrier or a stock company or anything of that nature.

I can attest to the fact that they are working, that they are very stringently regulated, they are serving a public purpose in Michigan, and that they are providing workers' compensation as the law provides, and they are provided under the manner that we feel is consistent with the law and that it is provided in the least costly manner, and the employee is getting the benefits that the law provides.

Mr. **Flippo**. If we disagree with the Vander Jagt bill, will the companies that are in your programs be able to get insurance, and at what increased cost would you think you would be talking about?

Mr. **Miron**. I think they would probably be able to get insurance through the assigned risk program in many instances, and in many instances in the voluntary market at a higher cost.

Mr. **Flippo**. John

Mr. **Allen**. We estimate the cost would be 35 to 50 percent higher if we had to go to the stock market for the same type coverage. And there are some companies that are reluctant to distribute this type insurance.

Mr. **Flippo**. Mr. Mastrovito?

Mr. **Mastrovito**. We have an assigned risk mechanism so that there would be insurance coverage for any employer who needed it. I can only agree with the others that it would be a higher cost. I could not give you an exact amount.

Mr. **Flippo**. Thank you, Mr. Chairman.

Chairman **Rangel**. Mr. Stark.

Mr. **Stark**. Thank you, Mr. Chairman. Mr. Allen, are there commercial insurance companies providing workmen's comp on Alabama?

Mr. **Allen**. Let me ask Mark Davis. Mark, could you respond to that.

Mr. **Davis**. Yes, sir. We have commercial insurance companies that provide workmen's comp in Alabama.

Mr. **Stark**. Do you know roughly what the breakdown would be in terms of how many workers are covered by commercial companies, and how many by self-insuring groups?

Mr. **Davis**. Well, the 10 funds have approximately 155,000 employees, and I think there's about 1.4 million employees now—four or five million—1.4, I believe.

Mr. **Stark**. So you have got 155,000 employees in 10 funds, and one would presume the balance of the employees are insured by commercial companies?

Mr. **Davis**. Yes, sir.

Mr. **Allen**. Well, the large companies are self-insured. Major companies with a lot of employees will have their own insurance funds.

Mr. **Davis**. Yes. We have over 300 individual self-insured employers in Alabama.

Mr. **Stark**. Let me back up a minute. Are you telling me that about 10 percent of the employees are covered by self-insurance funds?

Mr. **Davis**. Yes, sir.

Mr. **Stark**. Okay. And the funds have varying rates? There are different rates for different funds?

Mr. **Davis**. Their rates are the same as the National Council rates, basically.

Mr. **Stark**. And the National Council rates set the rates for all the employees in the State. So the commercial insurers are charging the same rates that the funds are charging?

Mr. **Davis**. Well, if you can buy a commercial policy, yes.

Mr. **Stark**. Well, you are telling me that commercial policies insure about 90 percent of the workers in Alabama?

Mr. **Davis**. No, sir.

Mr. **Stark**. Oh. That is what I am trying to get at. What percentage would you guess are insured by commercial companies?

Mr. **Davis**. I would not venture to guess, Mr. Stark, for the simple reason I do not know the number of employees covered by the individual self-insured employers.

Mr. **Stark**. All employees must, by law, be covered. There are no employees, legally, not covered?

Mr. **Davis**. Yes, sir. Only employers that have three or more employees, it is mandatory.

Mr. **Stark**. It is mandatory?

Mr. **Davis**. Yes, sir.

Mr. **Stark**. I see. Are the rates generally comparable between commercial companies and self-insuring costs, when all is said and done?

Mr. **Davis**. No, sir.

Mr. **Stark**. Why would anybody buy a commercial policy at all?

Mr. **Davis**. Well, a lot of people pay—they go ahead and buy the commercial policy because they're rather the insurance company handle it.

The funds band together, as a pool, their liabilities, to decrease them, and decrease the administrative costs of handling workmen's comp claims. A fund can have much cheaper administrative costs than——

Mr. **Stark**. But only the administrative costs. In other words, if the fees are set properly, the insurance company and the funds have got the same actuarial risk, right?

Mr. **Davis**. Well, they do, but you have a pool of employers who can definitely operate cheaper than an insurance carrier writing a lot of policies.

Mr. **Stark**. Well, why would the insurance carrier have any more cost if that insurance carrier were going to write this pool?

Mr. **Davis**. Well, most employers in these pools, the insurance companies do not want to write the small employers, and that is what the pools are geared to, members associations.

Mr. **Stark**. Why would Alabama not have a State-operated pool for that? Do you have a State fund?

Mr. **Davis**. No, sir.

Mr. **Stark**. Are you familiar with those States that do?

Mr. **Davis**. Yes, sir, and I really would not care to comment on that. [Laughter.]

Mr. **Stark**. Well, all is fair. It is my understanding that those States that directly operate a State fund are highly regarded.

Mr. **Davis**. Well, again, I do not want to comment on that because we do not have that type of system in Alabama. We have a very good operating one that we have right now.

Mr. **Stark**. Would there be any objection in Alabama if the Federal Government set minimum standards for benefits and reserves, and that sort of thing for workmen's compensation?

Mr. **Davis**. You are talking about just for Alabama?

Mr. **Stark**. No, for all the States. [Laughter.]

Mr. DAVIS. I do not know. I think we are operating on a good system right now. Each State has their own law as to benefits, and Alabama has one of the best benefit systems in the Southeast, and probably the United States, as far as a benefits package.

Mr. STARK. So your benefits, say, are better than Mississippi's?

Mr. DAVIS. Yes, sir.

Mr. STARK. Well, what I am getting at is, if the Federal Government is going to in effect waive its income, or help you in that, don't you think we should set the standards, so we make sure, if we are going to give Mississippi tax exemption, shouldn't they get their benefits up as high as yours? Why shouldn't somebody competing with the good State of Alabama say, right next door, "I have an advantage over you"?

Mr. DAVIS. Well, I prefer that Commerce answer that question.

Mr. STARK. Mr. Mastrovito, in Florida, do you have any better idea of what percentage of the workers are covered by self-insuring funds?

Mr. MASTROVITO. About 35 percent of our market is self-insured. About 20 percent in the worker's compensation self-insurers' funds, and about 15 percent in the individual self-insured employers.

I have estimated about a million of the 4½ to 5 million Florida workers are in the funds programs. Our individual employers are large employers, and probably proportionally have more workers than their numbers would dictate, but I could not give you a hard and fast estimate. I would guess, if I had to give you an estimate, that about 35 percent of the workers are self-insured.

Mr. STARK. Are in the self-insured funds?

Mr. MASTROVITO. Well, no, self-insured individually, or in a fund.

Mr. STARK. Okay. Now all workers must have workmen's compensation in Florida?

Mr. MASTROVITO. We have the same three, or more requirement as in Alabama.

Mr. STARK. So you are saying about 35 percent are self-insured, are in the pools, and 65 percent are insured by insurance companies?

Mr. MASTROVITO. That would be my best guess for you.

Mr. STARK. Are the same standards of benefits required for the funds that you approve? I presume that Mr. Gunter, in his office, set the standards for those in the 65 percent insured by private insurance companies?

Mr. MASTROVITO. The benefits are mandated by the worker's compensation law, and they are applied to everybody in the State, regardless of where the coverage is.

Mr. STARK. Are the rates competitive as between the self-insured and the commercial?

Mr. MASTROVITO. In our funds we require that they start with the same rate structure as the insurance companies, but they do provide a lower up-front cost because they have a discount structure off the standard rates that is more generous for small employers than the insurance industry uses.

Mr. STARK. But mostly for small employers?

Mr. MASTROVITO. Right. Well, this is what—our funds, the average premium in our fund, per employer, is about $11,500 per year.

Mr. **Stark**. But it is conceivable that a private insurance company could have a competitive rate for one reason or another?

Mr. **Mastrovito**. Yes, conceivably.

Mr. **Stark**. Yes. Did Florida ever consider going to a State-operated fund?

Mr. **Mastrovito**. There have been discussions of that over time, but I do not believe it is a political reality in Florida at this point.

Mr. **Stark**. And why would you guess that it would not be a political reality?

Mr. **Mastrovito**. Well, it has been hotly debated in our legislature, but it does not seem to have had much favor in the past, when it has been discussed.

Mr. **Stark**. Now if the State operated it, it would indeed be taxfree?

Mr. **Mastrovito**. Presumably. I am not competent to answer that.

Mr. **Stark**. Thank you very much. Mr. Miron, what is the breakdown in Michigan?

Mr. **Miron**. It is approximately the same. I would estimate that 40 percent of all employees are covered in a self-insurance program, which would be individual and groups. I do not have a breakdown between the groups and the individuals.

Mr. **Stark**. Where do you require workmen's comp? For every employee?

Mr. **Miron**. In effect every employee.

Mr. **Stark**. So even if you are below three, you have still got to have it?

Mr. **Miron**. If you have three people who work part-time at one time, you have to have it.

Mr. **Stark**. Okay. Do people with domestic servants in their home have to have it?

Mr. **Miron**. Yes.

Mr. **Stark**. Now are the private companies—when I say competitive—can you find premiums that cover the scale, both in the self-insured funds and in the private companies?

Mr. **Miron**. We have a competitive rating system in Michigan, and yes, you could, you know, depending upon the employer.

Mr. **Stark**. So some employers might be induced to go to a private insurance company, and some might find it better off to go to a fund, and that would depend on why the insurance company wants their business, or does not want it, and other considerations?

Mr. **Miron**. Yes, sir.

Mr. **Stark**. Okay. Basically the "insurance" cost—if that is a proper term—I put the word insurance in quotes—ought to be the same for a private mutual company, and a self-insured group, should it not? And the only difference really being what the private company wants to do with reserves?

I mean, isn't the basic difference between a self-insured fund, and say, Employer's Mutual of Wassau, or whoever might be doing it, how much the Employer's Mutual feels they can hang onto, or want to hang onto for reserves, over and above what your State might require?

Mr. MIRON. I think that might be better answered by some of the people who are coming behind us. They are making that initial decision.

I do recall that when we had the push to have group self-insurance, that one of the people who is going to speak later was there, and it was their position that the cost of administration would be substantially less, that they would be closer to the employers who were in the group, that they could perhaps do better safety.

Mr. STARK. Good. Has Michigan ever gone round with the idea of having a State workmen's compensation fund?

Mr. MIRON. We do have a competitive State fund at this time.

Mr. STARK. So the State operates a fund?

Mr. MIRON. That is a question that is before the court right now, of who operates it, but it was established in 1912 when our workmen's comp act was passed.

Mr. STARK. When the great Senator LaFollette established it in Wisconsin, right?

Mr. MIRON. That is right.

Mr. STARK. The Zeimans Act?

Mr. MIRON. Right.

Mr. STARK. Okay.

Mr. MIRON. They were in 1911 and we followed in 1912.

Mr. STARK. Okay. So there is a State-operated fund?

Mr. MIRON. Yes, sir.

Mr. STARK. Now they are clearly tax-exempt?

Mr. MIRON. Yes.

Mr. STARK. And so if you did not allow the self-insuring funds, these people could go into the State fund, is that right?

Mr. MIRON. They have generally operated as an insurance company, however, and have followed the same rates that an insurance company has charged.

Mr. STARK. And paid dividends to their members?

Mr. MIRON. I believe they have, yes.

Mr. STARK. I mean, they do not accumulate a surplus and use it to pave roads, or anything? [Laughter.]

Mr. MIRON. I do not think they are paving any roads.

Mr. STARK. I mean, the policyholders are entitled to any refunds if they have——

Mr. MIRON. I am not sure, Mr. Stark, how that does work.

Mr. STARK. I guess what I am getting at is, if you give somebody a tax exemption, there should be some Federal reason to do that. Now obviously States do not pay taxes when they operate a fund in order to provide workmen's comp. They also regulate the benefits.

And it would seem to me, that that gives each State the ability, if they choose, to operate basically a nonprofit fund. They can just have the State do it and thereby regulate it, and I would think that that takes it beyond our reach.

But it appears to me that some of you are talking about groups that are kind of in the middle. They are not actually run by the State, and they are not actually companies. They are just kind of in a gray area.

For instance, does General Motors run a fund in Michigan?

Mr. MIRON. No. They are individually self-insured.

Mr. **Stark**. I do not know what that means, exactly. They just——

Mr. **Miron**. That means there is not a fund. They are self-insured.

Mr. **Stark**. They are just self-insured, period.

Mr. **Miron**. They are self-insured. Right.

Mr. **Stark**. Would they be subject to this tax under the Internal Revenue——

Mr. **Miron**. I really do not have that competence.

Mr. **Stark**. Thank you.

Chairman **Rangel**. Mr. Vander Jagt, I indicated earlier that your prepared statement would be entered into the record, but I do know your concern here, and the legislation that you proposed is before this committee, and at this time before you inquire, you might want to make your opening statement.

Mr. **Vander Jagt**. I thank you very much, Mr. Chairman, and I thank you for calling these hearings on a subject that is very important to so many businesses, and so many workers across the country.

I thank you, and my colleague from Alabama, for covering for me so well while I was flying in from California.

I thank my colleague from Michigan, Congressman Levin, for participating in these hearings because it is an enormous problem in our State of Michigan.

Chairman **Rangel**. You mean Mr. Stark.

Mr. **Vander Jagt**. Well, I was not sure he was covering for me. [Laughter.]

Mr. **Vander Jagt**. Mr. Chairman, to show you how much I appreciate the fact that you did cover for me, rather than take the valuable time of this subcommittee in reading my statement, I would just like to have it placed in the record.

Without objection, I also would like to submit for the record a letter to you, Mr. Chairman, from the Governor of the State of Michigan, our former colleague, Governor Blanchard. This letter outlines the severity of the problem in Michigan, and the fact that some of these businesses would actually have to close down because insurance would not be available if this is allowed to go the way the IRS apparently wants it to go. I would like to submit that for the record.

Chairman **Rangel**. Without objection both of the documents will be entered into the record.

[The statement and letter follow:]

OPENING STATEMENT OF THE HONORABLE GUY VANDER JAGT

Thank You, Mr. Chairman. I want to commend you for promptly scheduling this hearing on the tax treatment of self-insured workers' compensation funds.

As you know, the Tax Reform Act of 1986 imposed a moratorium on IRS audits of these funds. The moratorium was imposed in response to an extensive IRS audit program started about five years ago. Most, if not all, of these audits have taken place in my home state of Michigan.

The IRS' audits of the funds were unexpected and unannounced and represented a significant change in prior IRS policies toward the funds. In these audits, the IRS, initially at least, took the positions that the funds were not entitled to mutual company status and that they should be denied a deduction for their policyholder dividend payments. Both of these positions are inconsistent with prior IRS positions and policies that had been applicable for about 20 years. They are also inconsistent with the state statutes and administrative rules under which the funds operate. These statutes and rules require the funds to provide insurance at cost. Amounts collected by the funds that are in excess of the amounts required to provide insurance at cost, and to meet certain expenses, must be returned to the funds' members in the form of policyholder dividends. The cost requirement, as well as the timing and payment of policyholder dividends, are strictly regulated and supervised by applicable state agencies. They are not left to the discretion of the individual funds. Prior IRS policies recognized this fact.

The IRS' recent audits of the funds indicate the tentative nature of administrative rules. For this reason I have introduced, with a great majority of my Michigan colleagues, permanent legislation relating to the tax treatment of self-insured workers' compensation funds—H.R. 1709. The legislation is modeled after existing Code section 501(c)(15).

H.R. 1709 is intended to terminate the current dispute between the IRS and various funds, as well as provide the funds with equitable tax treatment in the future. Should these hearings indicate that amendments to H.R. 1709 are appropriate, I would of course consider them.

In closing, Mr. Chairman, I want to bring to the Subcommittee's attention what I consider a major violation of the Moratorium by the IRS. The IRS, despite the moratorium, has continued to audit the funds. The audits have, in general, denied the funds a deduction for policyholder dividends. They have not denied them mutual company status. The IRS has adopted the position that these audits comply with the Moratorium because the mutual company status issue is not raised. As a sponsor of the Moratorium, I want to go on record as stating that it was my clear understanding that the moratorium was meant to stop all IRS audits. It was not meant to be narrowly interpreted or applied. I think other Members of this Committee have a similar point of view. For example, the announcement of this hearing states in part and I quote, "Section 1879(q) of the Tax Reform Act of 1986 imposes a one year moratorium on these audits to allow time for study of the appropriate classification of these entities, and the propriety of the timing of deductions for policyholder dividends." I hope the intended scope of the moratorium will be shortly clarified by the Committee.

Mr. Chairman, I would request that a copy of H.R. 1709 and my accompanying floor statements to be made a part of the record at this point. Thank you.

I

100TH CONGRESS
~~1ST SESSION~~

H. R. 1709

To amend the Internal Revenue Code of 1954 to clarify the tax exempt treatment of self-insured workers' compensation funds.

IN THE HOUSE OF REPRESENTATIVES

MARCH 18, 1987

Mr. VANDER JAGT (for himself, Mr. BROOMFIELD, Mr. CARR, Mr. CROCKETT, Mr. DAVIS of Michigan, Mr. DINGELL, Mr. FORD of Michigan, Mr. HENRY, Mr. KILDEE, Mr. LEVIN of Michigan, Mr. PURSELL, Mr. SCHUETTE, Mr. TRAXLER, Mr. UPTON, Mr. WOLPE, and Mr. BONIOR of Michigan) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to clarify the tax exempt treatment of self-insured workers' compensation funds.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Self-Insured Workers' Compensation Funds Tax Exempt Status Clarification Act of 1987".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. CLARIFICATION OF TAX EXEMPT STATUS OF SELF-INSURED WORKERS COMPENSATION FUNDS.

(a) IN GENERAL.—Section 501(c) of chapter 1 is amended by adding at the end thereof the following new subsection:

"(26) Any corporation, fund, or trust whose principal purpose is to function as a self-insured workers' compensation or workers' disability fund.".

SEC. 3. EFFECTIVE DATE.

The amendments made by this Act shall apply to all taxable years beginning before, on or after December 31, 1987.

TAX-EXEMPT TREATMENT OF WORKERS COMPENSATION SELF-INSURANCE FUNDS

HON. GUY VANDER JAGT

OF MICHIGAN

IN THE HOUSE OF REPRESENTATIVES

Monday, March 9, 1987

Mr. VANDER JAGT. Mr. Speaker, I am today introducing a bill to clarify the tax-exempt status of workers' compensation self-insurance funds. This legislation is intended to terminate a dispute which exists between the Internal Revenue Service in certain jurisdictions of the country and various workers' compensation self-insurance funds. I believe that prior practice in this area and a review of the existing statutes and its intent should lead to the conclusion that workers' compensation self-insurance funds are not taxable. Notwithstanding this view, the Internal Revenue Service in certain jurisdictions has concluded that these entities are subject to Federal income tax. The consequences of such treatment on both a retroactive and perspective basis would be severe. With respect to prior years, the tax liabilities could exceed the assets held by these funds. With respect to future years, such treatment could eliminate the viability of these funds which have been instrumental in reducing skyrocketing insurance costs of employers in a variety of industries. In some cases, the use of these funds has helped to avoid a nonavailability problem which these employers may well have encountered.

Recognizing that we are in a revenue conscious Congress, I believe that this legislation should be considered to have no revenue effect since it simply clarifies the treatment of current law which until relatively recently was viewed to be consistent with my proposed legislation, that is, these entities were viewed as tax-exempt.

My legislation is simply intended to extend the temporary solution which was contained in the Tax Reform Act of 1986. This problem came to the attention of myself, and Congressman DAN ROSTENKOWSKI, the chairman of the Ways and Means Committee, late in the process of the development of the Tax Reform Act of 1986. As a result, time for the formulation of a permanent solution did not exist. Recognizing that, the act contained a provision prohibiting the Internal Revenue Service from proceeding with audits on these entities through August 16, 1987. See the conference report of the Tax Reform Act of 1986 at II–848. My legislation would provide a permanent solution to this various serious concern which has been raised by the Internal Revenue Service audit activity. I will soon urge Chairman ROSTENKOWSKI to refer this measure to the Select Revenue Measures Subcommittee of which I am the ranking member for prompt consideration in hopes that this matter can be resolved promptly. I welcome any of my fellow colleagues who may wish to join me in cosponsoring the legislation.

MICHIGAN CARES

HON. GUY VANDER JAGT

OF MICHIGAN

IN THE HOUSE OF REPRESENTATIVES

Wednesday, March 18, 1987

Mr. VANDER JAGT. Mr. Speaker, I am today introducing a bill in conjunction with a great majority of my Michigan colleagues that will greatly clarify the tax exempt status of self-insured workers' compensation funds. These funds are totally and vitally important to over 6,000 Michigan employers and well over 2 million Michigan workers who can rely on these self-insured funds for workmen's compensation coverage. From these numbers alone, it is understandable why our Michigan Congressional delegation is unified in pressing for appropriate legislative action. I had first introduced this bill alone, H.R. 1489, just to get the ball rolling. Now, I am honored to do so for practically the entire Michigan delegation with special appreciation to Congressman JOHN DINGELL.

I want to quickly point out that this is not a Michigan bill. It is not a Michigan problem. It is not a Michigan solution.

This legislation is vital and important to funds that exist and extend coverage and hope in some 25 other States. Now that this Michigan Initiative has been introduced, we shall be seeking the support and help of the entire membership of the House of Representatives. We need legistation to preserve and protect the integrity of these funds which are under attack by the Internal Revenue Service. IRS is wrong. And, we shall prove it conclusively.

STATE OF MICHIGAN
OFFICE OF THE GOVERNOR
LANSING

JAMES J. BLANCHARD
GOVERNOR

April 3, 1987

Honorable Charles B. Rangel
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S.House of Representatives
1102 Longworth Building
Washington, D.C. 20515

Dear Congressman Rangel:

On July 2, 1986, I sent a letter to James Owens, Acting Commissioner, Internal Revenue Service, voicing my deep concern about a recent change in IRS policy and practice that is threatening the vitality of the 38 group funds that provide workers' compensation insurance coverage to more than 7,000 Michigan employers. Many of these employers are small businesses which will see a dramatic rise in their workers' compensation costs if this new IRS initiative is allowed to prevail.

I would like to reiterate those comments, through Congressman VanderJagt, as your subcommittee begins to consider effects of the expiration of the one-year moratorium as provided in the Tax Reform Act of 1986.

While 24 states allow group insurance funds to operate, Michigan apparently is the only state in which the IRS is instituting this new policy. In fact, half of Michigan's group funds have already been audited or are in the process of being audited. At least three funds, among the most well-established, have been cited for "deficiencies" ranging from $400,000 to $1.7 million in taxes owed. Under previous practice, these funds--organized and run as not-for-profit mutual insurance companies--had no tax liability.

Michigan law allows private sector firms from the "same industry" and public sector employers of the "same type of unit" to form group insurance funds as an alternative to purchasing coverage from a commercial carrier. These group funds have been instrumental in minimizing the cost of workers' compensation coverage as Michigan employers have been able to save anywhere from 10 percent to 60 percent of the cost they would otherwise pay in the commercial insurance market. Group funds have been particularly successful in promoting work safety programs and other loss control efforts that are sometimes not as apparent in more traditional insurance schemes.

The financial stability of such funds and their administration are stringently regulated by the Workers' Compensation Bureau of the Michigan Department of Labor. The state not only determines the initial rate a group fund must charge its members, but the state must approve the amount and timing of the refunding of any "surplus premium" whenever a fund's trustees decide that the fund has taken in more premium than is necessary to cover both current and future costs. These anticipated costs for future years are covered by contingency funds required by the state to be held in reserve to be paid out as needed.

Money that is not paid out as benefits in the current policy year, or is not held in "reserve" to cover future costs allocated against the current year, is considered excess premium and is returned to group fund members as "dividends". However, as mentioned above,the amount and timing of the dividends must first be approved by the state Workers'Compensation Bureau. In addition, any dividend issued to a group fund member is potentially subject to taxation depending on a given member's financial situation. Now, however, the IRS seems determined not only to tax dividends returned to fund members, but also to tax a portion of the reserves a group fund is required to retain by the state to meet future obligations.

Michigan's Workers' Compensation Bureau is nationally recognized for its vigilant approval and monitoring practices of group and individual self-insured funds. The state has clearly demonstrated its ability to determine what the appropriate level of reserves is for funds that have been scrupulously and effectively monitored by the state for more than a decade.

This potential shift in federal policy will cause Michigan's group funds to incur considerable expense in compliance and may well cause their demise.

I respectfully request that the tax status of these self-insured funds be resolved in a manner consistent with the way they were treated prior to the institution of the IRS audits.

I am deeply concerned about the survival of these funds and trust you will allow them to be treated in a fair and equitable manner.

Thank you for your consideration.

Sincerely,

James J. Blanchard

James J. Blanchard
Governor

Mr. **Vander Jagt**. Thank you, Mr. Chairman. I have no questions.

Chairman **Rangel**. Mr. Levin, do you have any questions?

Mr. **Levin**. No, Mr. Chairman.

Chairman **Rangel**. Mr. Flippo?

Mr. **Flippo**. Mr. Chairman, if I might just follow up on one point, I would like to clarify on a point that Mr. Stark was making, if I might have the gentleman's attention.

It is my belief that General Motors, or a large firm, can establish a self-insurance fund for workmen's compensation and the premiums are deductible.

Smaller firms that are not large enough to do that from an administrative viewpoint can turn today to, in Florida, and Alabama, and Michigan, and some other States, a small fund which achieves the savings and accomplishes the same thing that the large firm does, but they achieve those savings through administrative savings.

They have essentially the same payout, the same liabilities that exist, but they achieve the savings primarily through administrative economies of scale.

If they were denied that ability then in a sense they would be somewhat at a disadvantage, I believe.

As the gentleman comments in regard to General Motors and self-insurance, I just want to clarify this. I think the employment rate in Alabama, that is, those covered by self-insurance—you have those companies that are large enough to have their own self-insurance, and then you have a pooling of small employers who are not able to do that, and that is generally the purpose for which these were formed. I just wanted to clarify that point with the gentleman.

Mr. **Stark**. I thank the gentleman.

Chairman **Rangel**. Thank you very much for your testimony.

We will have the next panel. Richard Moore, administrator-fiscal officer, Detroit Tooling Association Worker's Compensation Fund, from Michigan. Linda Etkin, an attorney with Miro Miro & Weiner, from Michigan. Bruce Martin, president, Florida Association of Self-Insurers, from Florida. Hugh Ryan, Michigan Council of Self-Insured Group Administrators, and chairman of the Coalition to Preserve Group Workers' Compensation, from Michigan.

We have read the testimony of all of the witnesses. We understand how these insurance programs were formed, and in order to make certain that the Members have an opportunity to inquire we have the restrictions on the 5-minute rule, and Mr. Moore, you may proceed.

STATEMENT OF RICHARD L. MOORE, ADMINISTRATOR-FISCAL OFFICER, DETROIT TOOLING ASSOCIATION WORKER'S COMPENSATION FUND, DEARBORN, MI

Mr. **Moore**. Thank you, Mr. Chairman. Members of the distinguished panel, I thank you for allowing us to come here today and tell you of our problems.

I have given you a written statement. In the interest of brevity, I would like to sort of speak from the cuff, and speak from my heart.

We represent over 700 members in the State of Michigan. These people employ 40,000 highly skilled, highly technical employees and they have gone through years of specialized training.

They are vital to the automobile industry, to the steel industry, to the aircraft industry, to the defense industry, and we have had a great deal of difficulty in being able to compete in the world marketplace.

We not only have to fight our friends to the north, Canada, but our friends to the south. We have to fight Europe and the entire Far East.

We pay our highly developed people high wages, as high as $45,000 to $50,000 per year. We are competing with people in the Far East paying a dollar to $2 a day. We look for every possible avenue to reduce our costs, not only in the cost of workmen's compensation, but in other costs.

We are vital to this country because we provide the methods to improve the productivity of the employers in this United States since we provide the special machinery to the nation.

Several years ago, in approximately 1975, we discovered that the Michigan Timbermen's Association had developed a workmen's compensation fund for the purpose of reducing workmen's compensation costs.

Many of our people could not buy insurance at an affordable rate. Many of them were in assigned risk programs because of their size.

When you went into the assigned risk program back in 1975, you not only had to pay the State rate, you also had to pay an 8 percent penalty to that carrier who pulled your name from the file.

We looked at it, we studied it, we thought this was great, this was a possibility for our people to save money, to reduce their costs. We have been competitive because we took these costs, and started with only 14 companies, and today, we have approximately $20 million a year in annual premiums.

Now we do differ, we differ substantially from the insurance companies because we fight to take in the lowest possible premium dollar that we can get away with. We do not want to charge our people more dollars than what it is absolutely necessary to pay our claims and pay our expenses.

We were able, just in 1985, to have a 55 percent advance discount. That meant that we only collected from our people 45 cents on every dollar to pay our claims. The other 55 cents stayed in the companies. The companies were able to buy new machinery, they were able to create new jobs with it, and were able to compete in the world marketplace.

Last year we had a 50-percent advance discount. Now, one of the reasons that we are able to save money is because we care. We care about our members, we care about our employees, and we pay particular attention to safety programs, safety programs that were not available to us under the old system.

By working together, these elected trustees, and these hundreds of members, have been able to save hundreds of millions of dollars in the State of Michigan. In my fund alone, we have refunded in excess of $25 million in cash to our members upon receipt of approval from the State of Michigan.

We cannot do a thing in the State without going to the State and saying, "Mother, may I, Mother, can I give back all my money?" And every year we have done this and every year the State has come in and said, no, you shall set *x* number of reserves and you may hand back that.

So we have done this. We have done this in good faith. We have not tried to take money out of the Federal Treasury because our people have paid taxes upon receipt of these monies.

When we give the dollar back, the State comes to me and says, Dick Moore, you may now hand back this money, we have it out, in their hands within 48 hours. We do not delay. We get this money back because our people desperately need money. We are a cash-starved industry.

Now I am not going to talk about the "arsenal of democracy", Mr. Chairman, you have already read my statement on that, but we are a virtual industry to this country for the defense of this country.

Now I ask for the successful passage and consideration of House bill 1709. This is a godsend to us. We have an $18 million deficiency notice from the Internal Revenue Service. We are the fund that has a problem. We are the fund, though, that also volunteered. They did not come to us.

The IRS was attacking the smaller funds in Michigan. We stepped forward because we were the largest fund at that time, and we felt ourselves better able, and better financed, perhaps, to debate this battle. Whether we made the right decision a year ago, I do not know, but I think if we had to do it over we would do the same thing because we could not afford to let our smaller brothers out there fall.

I thank you very much for your attention, sir, and if there are any questions, I will be glad to answer them.

[The statement of Mr. Moore follows:]

April 7, 1987

Good morning Mr. Chairman and members of the sub-committee. My name is Richard L. Moore. I am the Administrator of the Detroit Tooling Association Worker's Compensation Fund. We were organized to assist the metal working industry in 1933 and presently represent over 700 companies employing approximately 40,000 specially skilled persons.

Our members design and build all kinds of tools, dies, jigs, fixtures, special machines, molds, gages and die cast dies. Since the vast majority of these jobs are high tech, it takes on the average of four years to properly train our apprentices.

Our industry was known as the arsenal of democracy in World War II and the Korean War, when our member companies transferred from peace time work to full time war production. In the eyes of many, it is a critical industry for the continued survival of this country. In addition, our tooling expertise is vital to closing the technology gap and increasing the productivity of American manufacturers.

In 1974 the Michigan legislature passed a law modeled after several other states, including Florida and Georgia, that permitted small companies of similar industry to pool their employees together for the purpose of providing workers' compensation. For approximately 20 years, prior to the Michigan law, these funds had been very successful in Florida. These funds give the small employer the opportunity to reduce their costs and have a voice in the handling of their claims. As you will no doubt learn, 26 states have now adopted statutes that permit funds of this type. In our state of Michigan there are 37 funds currently operating, reducing workers' compensation costs by tens of millions of dollars and permitting them to be more cost competitive. An example in point is our own fund. Our industry is in an extremely competitive market place. We not only face competitive pressures from other parts of the United States, but we also have to fight Europe, Canada, South America and the entire Far East. Our members are having to bid against countries that pay their employees as little as a dollar or two per day. It is not unusual to see our employees earn as much as $45,000 or more per year and because of our high productivity, technology, and good old American know how, we have been able to hang in, fighting for these jobs. It is ironic that the threat that we have been unable to solve is the threat posed by our own government. The savings, by pooling our workers' compensation in our industry, has been vital to our survival.

Since February 1, 1976 our Fund has advanced discounted $31,126,869 to our members. By advance discounting, I mean that we lowered our rates below the Michigan Workers' Compensation rate tables. In fact, we were able to discount 55% in 1985 and 50% in 1986 from the last published rate table of 1982. These advance discounts permitted our members to keep the money in their companies for the hiring of new employees, the purchase of new machinery and in the terrible years of the last recession to just plain survive. This has also given them sufficient capital to bid on new tooling programs and to finance such.

During these same years, our group has immediately refunded $23,898,014 back to the membership upon receipt of approval from the Michigan Department of Labor. Our members, of course, paid corporate taxes upon receipt of these refund dollars.

It has always been our intent to set our premiums at the appropriate level so that they were sufficient to pay our employees' injuries, cover our expenses and fund the loss reserves that may be incurred, but not so large as to require later refunds. We are a cash starved industry and our owners incur huge debts when they purchase new machinery, expand their operations, and they need every single dollar to meet expenses and to create new jobs.

Our Trustees are owners themselves, and we have fought every year with the State of Michigan to obtain authority to refund every possible dollar to our membership. In fact, the State would audit our open claims each year and usually increase our reserves prior to granting us permission to release premium refunds. Because we were obligated to return excess monies, we never reported taxable income and have operated in the same manner since 1976. Our industry has retained two prominent law firms, three public accounting firms, including the nationally recognized names of Touche Ross and Peat Marwick Mitchell, and have reviewed five private letter rulings stating that these funds were reporting their income properly. The IRS never questioned our reporting, and we relied on ten years' experience. Group funds have been in existence for over 50 years and have operated in a similiar manner.

Now after years of reliance, the Treasury wants to change the rules. Based on the clear and obvious correctness of our actions, we volunteered to be the test case and asked to be audited. This was also done so that the smaller organizations would not be forced to agree to unreasonable constructions. Much to our surprise, two IRS agents appeared on the scene and told us that we were in violation of the law, and that we owed millions of dollars in back taxes. We think it is terribly unfair to change the rules in midstream. We have relied on the IRS's acceptance of our reporting method for 10 years and, in addition, we have strictly followed the requirements of the State of Michigan and their guidelines. Now for the first time, we are threatened with financial ruin. We have a deficiency notice from the Internal Revenue Service for an amount in excess of $18,000,000, which exceeds our total premium collected for that time period. We have attempted in good faith to deal with the auditing agent, the Detroit District Director, and have met with the Chief Tax Counsel and his staff, but have not been successful.

As in each fund, our members have to sign a joint and several liability statement with no maximium limit on exposure. If it is the will of the Congress that we pay the $18,000,000 it will set off a cataclysmic reaction that will most likely bankrupt not only our group fund, but our membership. Our reasoning is that we have very little surplus in hand, due to running the Fund with limited margin. The tax assessment, after eliminating our reserves for identified and known claims, would fall upon our membership. Since the members have their assets tied up in expensive machinery and buildings with little surplus cash available, they would be forced into bankruptcy. They would have little hope to receive fair or realistic prices for their machinery, if they all were forced to the auction block at the same time.

As the weak companies fall first, their unpaid share of the accumulated liabilities would fall on those stronger ones, but they too would eventually fall, because no one would be able to meet the tax plus be able to pay the employees' injuries. Last year alone (1986) we paid out in cash over $6,200,000 on over 7600 injuries. After the entire industry collapsed, the State of Michigan would have to pay our claims up to 10 million dollars at which point our reinsurance company would enter. If the aforementioned events do come to pass, these United States will lose 40,000 high tech and high pay jobs, and will lose a vital part of our national economy. As severe as this may be, it pales in comparison to the catastrophe which would befall this nation, as other industries like ours, who currently provide workers' compensation insurance in this manner, begin to collapse.

Over 70 years ago, various states were told by the Congress that they had to implement workers' compensation programs to provide benefits to the injured worker. A company is not permitted to operate with employees without workers' compensation coverage. It is, in its' purest form, a tax on employers for them to do business and to tax these self-insured funds is, in essence, placing a tax upon a tax. In many Michigan corporations, this premium for workers' compensation represents more dollars than the total profits of the companies. This is not a trivial matter, but in fact, often represents the difference between an ongoing or a closed business.

In conclusion, we sincerely thank all of the many sponsors of HR 1709 and we heartily support the bill. It not only addresses the serious and potentially devastating problem of the retroactive tax deficiency, but it also permits the small businessman to continue to be competitive in a very competitive world.

Richard L. Moore

Chairman **Rangel**. Thank you. Miss Etkin.

STATEMENT OF LINDA W. ETKIN, ATTORNEY, MIRO MIRO & WEINER, COUNSEL FOR MICHIGAN COUNCIL OF SELF-INSURED GROUP ADMINISTRATORS

Ms. **Etkin**. Good morning, Mr. Chairman, and members of the subcommittee.

I thank you for giving me the opportunity to be here today, and what I would like to do is present a little bit of the tax background to the bill that is under consideration.

These funds have filed their tax returns for the years of their existence in reliance upon the only authority that they had to go by—the code, the regulations, court cases, and specifically six previously issued letter rulings, which the IRS issued, addressing funds that really differ in no substantial way from every other fund in the country.

In each of these letter rulings, the IRS addressed the issue of how the group fund should treat for tax purposes the excess amounts which the funds are required to hold during the State-imposed waiting period, but which the funds must, as soon as possible, return to their members.

In each of these six rulings the IRS concluded that the amount which the funds ultimately have to return are policyholder dividends, and, therefore, are deductible under the Internal Revenue Code deduction for dividends to policyholders.

In addition, each one of these six rulings concludes that the fund can deduct in the year in which these amounts are designated, the dividends that are declared in that year, even though that amount may not be paid until a subsequent year, and even though the amount can be paid only upon the approval of the State regulatory authority.

The funds have filed in reliance upon these rulings. Now in the context of the Michigan audits, the IRS has drastically changed its position upon which the funds have relied.

Now the IRS is arguing that the funds must satisfy the all-events test before they are permitted to deduct their policyholder dividends.

This is not a new argument for the Internal Revenue Service. This is a fight that the Internal Revenue Service has attempted to wage for many years, and which the courts have pretty consistently rejected, except in certain limited circumstances.

The courts have held, almost consistently, that the all-events test applied to normal accrual basis taxpayers does not apply to insurance companies.

The IRS, in the six rulings where the IRS actually examined the group funds, reached the same conclusion. They concluded that funds may deduct these dividend amounts in the year declared, even though they may not be paid until a subsequent year, and even though they may not be approved by the State regulator for distribution until a later year.

If the funds have to go through the regulatory, administrative and judicial process to resolve this problem, we are confident that they will succeed, but it will be a very hollow victory because the funds will not survive to learn the outcome of this litigation.

These funds do not present the types of abuses which are presented by normal commercial insurers. They are highly regulated in every aspect of their operation. They are not permitted to engage in cash flow underwriting. They collect only the minimum amount which they feel they must have in order to provide the benefits which they will be obligated to provide.

And they are extremely limited in the investments they can make. The State regulations limit them to essentially cash equivalent type investments.

These funds are not owning shopping centers, they are not operating businesses. They are strictly trying to collect the minimum amount they can collect, pay their expenses, pay their benefits, and return every excess dollar as soon as possible.

The IRS says that they do not know where the detrimental reliance is in this case. You know, they have issued six rulings in the past and they say rulings are not precedent which is true. Private letter rulings are not precedent.

But in this case, this was the only authority that these funds had to look at to determine how they should file their tax returns.

And Mr. Moore, whose fund is sitting with an $18 million deficiency notice, will tell you that he detrimentally relied on the Service's prior position.

I believe that the bill that has presently been presented is a good solution for these funds. I would urge that Congress not make the decision to force these funds to go through the judicial process to solve the problem because the solution will not be meaningful at that point. I think the solution is with Congress.

[The prepared statement follows:]

TESTIMONY OF MIRO MIRO & WEINER REGARDING THE PROPER TAX TREATMENT OF WORKERS' COMPENSATION SELF-INSURANCE FUNDS

SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES

Miro Miro & Weiner, counsel for the Michigan Council of Self Insured Group Administrators (MCSIGA), submits this statement on behalf of MCSIGA and various members in support of H.R. 1709, 100th Cong., 1st Sess. (1987):

I. The History of Group Workers' Compensation Self-Insurance Funds

State workers' compensation laws ensure prompt and equitable resolution of employee claims arising from work-related injury. These laws provide a fixed level of benefits based upon the employee's injury without regard to the employer's negligence.

Virtually all states now permit an employer to choose from several alternatives to satisfy its workers' compensation obligations. First, the employer may obtain insurance from a commercial insurance company. Second, the employer may obtain coverage from a public accident fund. Third, an employer whose net worth is sufficiently large may self-insure. Finally, a group of employers who cannot individually self-insure may, in thirty states, obtain the benefits of self-insurance (i.e., lower cost and greater claims control) by pooling their workers' compensation risks and forming group workers' compensation self-insurance funds ("group funds").

Several factors have contributed to the popularity of group self-insurance. Perhaps the most significant factor is the difficulty experienced by small firms engaged in high risk industries in obtaining affordable insurance from commercial carriers. In Michigan, for example, employers in the logging industry were finding it impossible to survive, given the existing cost for workers' compensation insurance. Since the private insurance industry was unable to serve these companies, they required alternatives which would permit them to remain in business. Group funds offered such a solution.

II. What Are Group Funds?

Group funds usually are unincorporated associations or trusts comprised of a number of employers who have joined together to provide workers' compensation coverage at cost. Group funds, like self insurers, generally represent a single risk group, since membership is usually restricted to a particular industry or trade group. For this reason, the group fund is better able to understand the risks unique to that industry and to assist in the development and implementation of safety programs to reduce those risks. Group funds provide a higher level of service and their employees return to work sooner. Consequently, group funds have reduced their members' cost of workers' compensation coverage by approximately fifty percent.

Fund members pledge their combined net worth to guarantee sufficient financial strength to satisfy their workers' compensation obligations. This is accomplished through an indemnity agreement, signed by each fund member, under which the member promises to be jointly and severally liable for the workers' compensation liability of every other member.

This joint and several liability of fund members is the touchstone of group self-insurance. It protects the members' employees by ensuring that each member of the association is ultimately responsible for the payment of each employee's claim. As a result of the joint and several liability, each member is keenly concerned about the risks of the other members of the fund and with policing safety and claims management.

Some commercial insurance companies, too, assess their members in the event the company's reserves prove to be inadequate to meet the claims asserted, but these assessments are limited to a multiple of the members' premiums. There is no such limitation with respect to group funds. Each member is liable for all of the workers' compensation liability of every other member.

III. Operation of Group Funds

State statutes and regulations contain very specific requirements for forming and operating a group fund and adopting bylaws and indemnity agreements. In fact, in several states the precise language of the indemnity agreement is set forth in the statute or regulation.

The method of determining premiums is specified by the state regulator. The regulator varies from state to state. In more than half the states which permit group funds, the funds are regulated by the state agency responsible for administering the workers' compensation laws. In the remaining states, the group funds are regulated by the agency responsible for monitoring insurance companies within the state. Regardless of which agency regulates the group fund, the focus of the regulation is to ensure that the funds are financially able to meet their members' workers' compensation obligations.

Most states require each group fund to secure excess insurance coverage (as protection against catastrophic losses) and to retain a service company approved by the state regulator. These service companies provide expertise in risk management and claims adjustment. The service company assists the group fund in all aspects of the fund's operation, including the evaluation of claims and the determination of the appropriate level of reserves.

States require that each group fund maintain separate records for each year of operation. This accounting by fund year ensures that reserves are at the appropriate level for the claims those reserves will be used to satisfy. The level of reserves is determined by the fund's service agent who examines the claims experience of the fund's members and industry experience and determines the portion of the fund's assets which will be required to satisfy incurred, but unpaid, claims.

If the premiums have been determined correctly, there should be money available to pay all claims arising during the year and to provide sufficient reserves to meet future claims. If there is money left over after providing for all claims and reserves, then all remaining amounts ("excess") must be returned to the fund's members. The group fund must obtain approval from the state regulator as to the timing of the refund.

The state regulator is actively involved in approving the return of the excess. Most states impose a "waiting period" during which the excess may not be returned. The waiting periods range from six months to two years. In addition to the waiting period, the regulator may prohibit the group fund from distributing any excess until some later time because the regulator disagrees with the fund's appraisal of the risks or the adequacy of the reserves to meet those risks.

The obligation to return this excess is the basis of the dispute between group funds and the Internal Revenue Service (the "Service"). The group funds maintain that their liability to return the excess is fixed and unconditional once they have determined their reserves as of the end of the year and, therefore, the liability can be deducted from their income immediately. The Service maintains that this deduction can only be taken in the first taxable year in which the group fund formally declares a dividend in the amount of the excess to the members and distribution is approved by the state regulator.

IV. Federal Taxation of Group Funds

As observed by the Tax Court of the United States, "[t]he business of insurance has proven over the years an extremely difficult subject for Federal taxation." *Penn Mutual Indemnity Co. v. Commissioner*, 32 T.C. 653, 654 (1959). The provisions of the Internal Revenue Code relating to the taxation of insurance companies are lengthy, complex, and technical. To a large extent, these provisions reflect the peculiarities of the insurance business and incorporate many insurance terms of art which "can be understood only by reference to industry practice and history." *Bituminous Casualty Corp. v. Commissioner*, 57 T.C. 58, 81 (1971), *acq.*, 1973-2 C.B. 1. In light of the technical and complex nature of the taxation of insurance companies, it is not surprising that group funds, which are themselves a hybrid, have experienced difficulty in determining how they should report their activities for federal income tax purposes.

A. Prior Tax Treatment of Group Funds

The Service has considered the tax treatment of group funds in seven private letter rulings issued from 1981 to 1985.[1] The Service, in the first six rulings, focused on the following issues:

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[1] Private Letter Rulings 8117035 (January 27, 1981); 8314019 (December 23, 1982); 8316033 (January 13, 1983); 8325042 (March 18, 1983); 8404031 (October 21, 1983); 8405034 (October 31, 1983); 8526012 (undated).

1. **Are group funds taxable as mutual insurance companies under § 821(a) of the Internal Revenue Code?**

The Service answered "yes" in each ruling.[2]

2. **How should excess amounts held in a reserve during the state-imposed waiting period be treated for income tax purposes?**

All six funds requesting the rulings, like all group funds, were obligated to return all excess amounts to their members, and all were subject to state regulations restricting the disbursement of the amounts. The Service determined that the excess amounts constituted "dividends to policyholders," which are defined under Code § 822(e)(1) as "amounts returned where the amount is not fixed in the insurance contract but depends on the experience of the company or the discretion of the management." Code § 832(c)(11) provides that in computing taxable income, an insurance company is allowed to deduct "dividends and similar distributions paid or declared to policyholders in their capacity as such." The term "paid or declared" is to be construed "according to the method regularly employed in keeping the books of the insurance company." Code § 822(e)(2). The letter rulings each cited Rev. Rul. 57-134, 1957-1 C.B. 210, which provided that insurance companies employing the accrual method of accounting "may deduct, in the year of declaration, dividends paid in a *subsequent* year to policyholders where the dividends are declared as an amount representing all or a portion of the net profits of the company as of the end of the taxable year." [Emphasis added.] Based upon the foregoing analysis, each ruling concluded that dividends are deductible in the year in which the dividend is declared (provided that the declaration creates an indebtedness or accrued liability) irrespective of when the liability is paid. In two of the letter rulings,[3] the Service approved the funds' deduction of dividends in the year of declaration even though the state-imposed waiting period was twenty-four months after the end of the year. The Service also authorized deduction of dividends in the year of declaration in PLR 8404031, in which the dividends declared by the fund could not be paid until the expiration of a one-year waiting period, and then only upon the approval of the state regulatory authority. The Service concluded in each of these rulings that the fund's *declaration* of the dividend was the key to current deductibility.[4]

In reliance upon these rulings, upon industry practice, and upon the advice of the funds' attorneys and accountants, most of the group funds have filed their tax returns as mutual insurance companies and have deducted, in the year of declaration, the excess amounts each year as dividends to policyholders.

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[2] The Service relied on Rev. Rul. 74-196, 1974-1 C.B. 140, which set forth the following definition of a mutual insurance company:

> While neither the Code nor the regulations thereunder defines a mutual insurance company, the courts have found the following characteristics to be among those indicating a mutual insurance company:
>
> 1. the right of policyholders to be members to the exclusion of others and the right of such members to choose the management;
>
> 2. the sole business purpose is to supply insurance substantially at cost;
>
> 3. the right of members to the return of premiums in excess of those amounts needed to cover losses and expenses; and
>
> 4. common equitable ownership of the assets by the members.

[3] PLR 8117035 and PLR 8325042.

[4] PLR 8526012 is the only ruling which reached a different conclusion. The group fund in that ruling, for undisclosed reasons, had not filed its tax returns as a mutual insurance company, and did not request a ruling on that issue. With respect to the dividend issue, the Service focused on the fact that the state regulatory agency had opined that "dividends do not come into existence until approved by the [state insurance] commissioner." Consequently the letter ruling concluded that the dividends declared by the fund were not deductible until approved by the state's insurance commissioner. The Service reasoned that, in that case, the dividend declaration did not by its terms "create a binding and enforceable obligation" on the part of the fund to pay the dividend to its members. It should be noted that Michigan, the state whose group funds are presently being audited, unlike the state in PLR 8526012, expressly provides that dividends declared by the trustee are "a fixed liability of the fund at the time of declaration," not at the time of approval by the regulator.

B. The Michigan Audits

The Service initiated audits of the Michigan group funds in early 1986. The Service's present position, as stated in two Notices of Deficiency issued to date to Michigan funds, is (i) group funds are taxable as "insurance companies other than life or mutual;" and (ii) dividends to policyholders are not deductible until both declared by the fund *and* approved for payment by the state's regulatory authority. The two funds which received the Notices of Deficiency do not differ in structure or operation from the funds considered in the six letter rulings discussed above. Michigan, exactly like the state in PLR 8404031, imposes a one-year waiting period and requires state approval prior to distribution. Thus, the Service's present position, as expressed in the Michigan audits, represents a significant departure from the approach taken by the Service in its earlier rulings.

C. Analysis of the Tax Issues

1. The Mutual Insurance Company Issue

The question of whether group funds should file their tax returns as mutual insurance companies is not the critical issue to the funds.[5] The group funds, in general, view themselves as pure conduits: they collect their members' money, pay all of the expenses and claims, and then return whatever remains to their members. Philosophically, and in operation, the group funds are closest to mutual insurance companies and, therefore, they have filed their returns as such.[6] This practice has previously been approved by the Service in the letter rulings noted above.

2. The Dividend Issue.

The critical issue to the funds is the determination of when the amount allocated to the excess reserve (the "reserve for dividends to policyholders") is properly deductible. In accordance with the position taken by the Service in its prior rulings, the funds, each year, have deducted the net increase in the reserve for dividends declared to policyholders, although the dividend amount is not paid until some time in the future. The Service, although having approved this practice in the past, is now arguing that the dividend amounts are not deductible upon declaration because, until approved by the state regulatory authority, the dividends are too contingent to be deductible. The Service, in effect, is now arguing that the "all events" test should be applied to the deduction of policyholder dividends.

Under the law generally applicable to accrual method taxpayers, an expense is deductible in the taxable year in which all events have occurred which determine the fact of the liability, and the amount of such liability can be determined with reasonable accuracy. This is referred to as the "all events" test. The courts and Congress have long struggled with the meaning and application of the "all events" test in non-insurance settings; a struggle which continues to date. The "all events" test is especially difficult to apply to insurance companies because of the nature of insurance.

a. The "annual statement" method of accounting

The accounting rules applicable to ordinary businesses would distort income if applied to insurance companies. This is because, unlike most businesses, insurance companies receive their income (premiums) in advance, and their costs (payments of claims and related expenses) arise afterward. The effect of taxing premiums when received and allowing deductions only when the liabilities become fixed would result in the initial taxation of a large amount of "income" which would never in fact become income, as it will be used to settle claims or to pay expenses. Congress recognized the need to permit insurance companies to utilize a special method of accounting in computing taxable income. Accordingly, the provisions of the Code relating to insurance company taxation expressly provide for taxable income to be computed using the method of accounting approved by the National Association of Insurance Commissioners (the "NAIC").

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[5] When the dispute between the Service and the group funds first arose, it was believed that the characterization of group funds as mutual insurance companies for tax purposes was the major source of controversy. It later became apparent that this issue was not critical. The difference between taxation as a mutual or stock insurance company is, under present law, a distinction with little practical significance. The Service has conceded that, under present law, group funds should be taxed as mutual insurance companies.

[6] It is important to note, however, that in the absence of clear direction from the Congress, this approach was not uniform. Many group funds operated and reported income as trusts.

The NAIC has developed an accounting method (the "annual statement method") which accurately reflects insurance company income and which the NAIC requires insurance companies to use in preparing their financial statements. The annual statement method of accounting recognizes that a portion of the premiums received by the insurance company will be used to pay future expenses and claims, and consequently permits the deduction of estimated expenses and estimated losses.

Section 832(b) of the Code requires property and casualty insurance companies ("insurance companies") to use the annual statement method of accounting in computing their underwriting income. As a result, an insurance company's deduction for losses incurred includes contested liabilities as well as amounts that are estimated. Indeed, it has been recognized that the annual statement method of accounting is at odds with the fundamental principles of the accrual method. *See Lincoln National Life Insurance Co.* v. *United States*, 582 F.2d 579 (Ct. Cl. 1978); *Bituminous Casualty Corp.*, 57 T.C. 58. Group funds, although not generally required under state law to file NAIC annual statements, also use the annual statement method of accounting.

b. The "all events" test

The Service has often challenged the use of the annual statement method of reporting by insurance companies and has asserted that items are not deductible until the "all events" test has been satisfied. The courts, with few exceptions, have rejected the Service's position. The Tax Court in *Bituminous Casualty Corp., supra*, a case to which the Service has acquiesced, recognized both that insurance company accounting is "fundamentally at odds with the all events test" and that the Code clearly adopts the basic approach of the annual statement method in computing underwriting income. The courts have not applied the "all events" test to insurance companies except in cases where the specific deduction is usually determined under a "non-insurance" code provision or where the Code or the Treasury Regulations contemplate a variance from the use of the annual statement method. *See Western Casualty & Surety Co.* v. *Commissioner*, 571 F.2d 514 (10th Cir. 1978), *aff'g* 65 T.C. 897 (1976); *Hanover Insurance Company* v. *Commissioner*, 598 F.2d 1121 (1st Cir. 1979).[7]

In sum, the annual statement method has been accepted by the courts as a proper accounting method for insurance companies. The all events test has therefore been recognized as generally not applicable to such companies.

c. Deduction for dividends to policyholders

Section 832(c)(11) provides a deduction for dividends and similar distributions paid or declared to the policyholders. Under § 832(c)(11), the term "paid or declared" is to be construed in accordance with the method of accounting the insurance company regularly uses in keeping its books. The annual statement method computes the total amount of the dividend deduction by adding to the actual dividends paid during the year the reserve for declared dividends at the end of the year less the reserve at the beginning of the year.

As discussed above, the Service has held in Rev. Rul. 57-134, 1957-1 C.B. 210, and in six private letter rulings, that accrual basis insurance companies can deduct policyholder dividends in the year of declaration, even though the dividends are declared in unspecified amounts that represent all or a specific portion of the current year's net income, and even though the dividends are not paid until later years.

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[7] The Supreme Court has considered the status of the annual statement method by insurers only in a footnote to a case. In *Commissioner* v. *Standard Life & Accident Insurance Co.*, 433 U.S. 148, n.24 (1977), the Court stated:

> Evidence of congressional respect for NAIC accounting methods is not limited to the portion of the Code concerning life insurance companies. In defining "gross income" and "expenses incurred" for purposes of taxing certain other insurance companies, Congress expressly requires computations to follow "the annual statement approved by the National Convention of Insurance Commissioners." 26 U.S.C. §§ 832(b)(1)(A), (b)(6).

433 U.S. at 161.

In *Bituminous Casualty Corp.*, *supra*, the Tax Court reached the same conclusion. In holding, *inter alia*, that the reserve for dividend payments was a reasonable estimate of the amount that would be required to be returned to policyholders and was thus a proper deduction, the court approved the use of the NAIC annual statement to compute deductions and stated that the Treasury Regulations provide for deductions with respect to dividends based on experience and on reasonably accurate estimates. Thus, the court specifically contemplated that deductions are to be allowed for dividends that have not accrued under the "all events" test.

In holding the dividend reserve deductible, the *Bituminous Casualty* court stated:

> The Annual Statement method of accounting relies extensively on the use of estimated amounts which would be improper under general tax accounting. Thus, for example, instead of taking into income all of the premiums received or accrued, casualty insurance companies take into account only the portion of those premiums which are estimated to be "earned." Similarly, the major deductions from income are "losses" and "loss adjustment expenses," which are again estimated amounts. The deduction of these loss and loss adjustment expense items is fundamentally at odds with the "all events" test: The items include amounts for liabilities with are not established, but, on the contrary, vigorously contested; they include, in the case of the loss adjustment items, expenses which will not only be paid in the future, but which are attributable to events which will not even occur until the future, including future overhead; and they are so unsusceptible of accurate estimate that Internal Revenue Service rules applicable in certain contexts provide that estimates will be considered in aggregate amounts rather than individually and will not be disturbed if, over a period of years, they are on the average within 15 percent of the final figure.

Bituminous Casualty Corp., *supra* at 77-78.

Accordingly, *Bituminous Casualty* is direct authority for the proposition that dividends declared or paid by insurance companies are deductible under the annual statement method and that the "all events" test is inapplicable. Therefore, the Service's present position with respect to the group funds, as stated in the Notices of Deficiency referred to above, is inconsistent with the Code, the regulations, the decisions of the courts considering the issue, and the Service's own position as previously enunciated in its published and private rulings.

Notwithstanding the clear inapplicability of the "all events" test to the deduction of dividends to policyholders, the deduction taken by the group funds does, in fact, satisfy the requirements of the "all events" test. The group funds' bylaws, indemnity agreements, and the state statutes and regulations require that all excess amounts *must* be returned to the members. The only uncertainty that exists at the time of declaration is the exact dollar amount that will actually be distributed and the time when it will be distributed. Uncertainty of this nature does not change a fixed liability into a nondeductible contingent liability.

Two recent cases, one decided by the Supreme Court and one in which *certiorari* has been granted, have addressed this precise issue. In *United States* v. *Hughes Properties, Inc.*, 54 U.S.L.W. 4572 (1986), an accrual basis gambling casino operated slot machines which featured a "progressive" jackpot that increased as more money was gambled on the machine until the jackpot was eventually won. A state regulation prohibited the casino from reducing the jackpot amount without actually paying the jackpot.

At the end of each year, the taxpayer deducted its liability for progressive jackpots under § 162 of the Code as an ordinary and necessary business expense. The Service disallowed the deduction on the ground that until the progressive jackpot was actually won, the taxpayer's liability to pay it was contingent and therefore not a deductible expense.

The Court held that the taxpayer properly deducted the accrued liability at the end of each taxable year, since the effect of the state regulation was to *fix* the taxpayer's liability. The Court observed that the "remote and speculative possibility" that the jackpot might *never* be won did not change the fact that, under state law, the taxpayer had a liability for the jackpot amount. The Court further observed that the taxpayer's inability to identify the winning player during the year in which it deducted the amount was not relevant to whether there was a fixed liability. Accordingly, the Court allowed the deduction since the liability was fixed, the amount of the liability could be ascertained, and it was only the time of payment and the winner's identity that remained uncertain.

In *General Dynamics Corp.*, 8 Ct. Cl. 250, *aff'd*, 773 F.2d 1224 (D.C. Cir.) *cert. granted*, 54 U.S.L.W. 3823 (1985), an accrual basis corporation and its accrual basis subsidiaries were self-insurers of their medical care plans. The taxpayers deducted as a business expense an estimate of their liability for medical care expenses incurred by employees whose claims had not been filed or processed by the end of the year. The Service argued that the "all events" test had not been met because, until the claims had been filed and the claims processor reviewed and determined the amount of the liability, the taxpayers' obligation to pay the benefits was uncertain and, therefore, contingent. The Claims Court opined that, although the claims processing procedure was a necessary event in obtaining reimbursement under the plans, it was a mere administrative step that did not preclude satisfaction of the first prong of the "all events" test - demonstrating that the fact of liability was certain at the end of the taxable year. The Claims Court observed that the filing and processing of claims are merely ministerial steps and are not a condition precedent to establishing the fact of liability. Both the Claims Court and the Circuit Court held that the last event necessary to fix the taxpayers' liability was the *occurrence* of the insured event: the employee obtaining medical services. The taxpayers were not predicting future events, but rather estimating the amount of their fixed liability for events which had already occurred.

With respect to the second prong of the "all events" test, the Court held that when all of the facts that determine the existence of a liability have occurred during the taxable year, and the amount, although not definitely ascertained, is capable of being estimated reasonably accurately at the end of the taxable year, a deduction is to be allowed.

Both *Hughes Properties* and *General Dynamics* indicate that the "all events" test is satisfied provided that the fact of liability is established during the taxable year, even though there may be conditions subsequent which might absolve the taxpayer from the liability. The cases further indicate that it is not necessary to know the exact amount of the liability, to whom it is owed or when it will be paid, as long as the taxpayer has incurred a fixed liability during the taxable year. Thus, even if the "all events" test were applicable to the deductibility of dividends by group funds, the application of the principles set forth in *Hughes Properties* and *General Dynamics* to the groups' dividends still would not support the position which the Service has now taken. The group funds are obligated under state laws and regulations, and under their bylaws and indemnity agreements, to return all surplus amounts to their members. Once a group fund sets its reserves for losses incurred, determines that an excess exists, and declares that excess as a dividend, the liability is fixed. The state regulatory authority relates only to the timing of the distribution; it does not affect the liability itself. Any uncertainty as to the precise amount of the dividend or when it will be paid is irrelevant under the logic of *Hughes Properties* and *General Dynamics*. State approval is not a condition precedent to the underlying liability, and thus the "all events" test is satisfied upon declaration of the dividend.

V. Conclusion

Group funds have successfully provided workers' compensation coverage at one-half the cost charged by commercial insurance companies to small employers who would not otherwise be able to survive. The savings have been realized through careful risk management, the implementation of safety programs, and the prompt return of all excess amounts to members subject only to the state-imposed waiting period.

The manner in which group funds have reported their activities for federal income tax purposes is entirely consistent with the Service's private letter rulings regarding the taxation of group funds. The Service has now changed its position asserting that the group funds have improperly reported their taxable income. The group funds have been significantly affected by the Service's change in position. Like all insurance companies, group funds determine their premiums based upon their best estimate of the prospective loss experience of their members and the projected costs and expenses they will incur. By returning all excess amounts to their members, however, the funds' reserves are sufficient only to cover the remaining claims liabilities for prior years. Accordingly, if the group funds are required to pay a tax liability relating to past fund years, they will be bankrupt.

If the funds are required to pursue their remedies through litigation, the delays caused by the litigation will have a devastating effect on the group funds (and on their members and their employees). As a result of the threatened tax liability, the group funds are already experiencing tremendous difficulty in obtaining the necessary reinsurance of their risks required by state law and regulation, are losing present members, and are having difficulty attracting new members. An analysis of the relevant law indicates that the group funds will ultimately prevail in the pending litigation. However, by the time the litigation is resolved, including the time for appeals, the issues will be moot as the group funds will not survive to learn the outcome. Furthermore, because of differences between funds and among the state statutes and regulations, it is likely that the same issues will be tested in different courts with different results. Accordingly, the only real solution to the group funds is with Congress. Congress, by clarifying the intended application of the present federal income taxation laws to group funds, and by providing a clear guide to their treatment in the future, can resolve the issues with a meaningful finality.

Mr. FLIPPO [presiding]. Mr. Martin, you may proceed.

STATEMENT OF BRUCE G. MARTIN, CAE, IMMEDIATE PAST PRESIDENT, FLORIDA ASSOCIATION OF SELF-INSURERS, WINTER PARK, FL

Mr. MARTIN. I appreciate the opportunity to testify this afternoon. My written testimony will be entered in the record, and so I will summarize that and highlight some issues I think that have come up this morning.

In supporting the statement just made by Ms. Etkin, we in the self-insurance industry have been relying on the only authorities that we have been able to find which are primarily private letter rulings. There also was a revenue ruling, 83-172, which addressed some of the specific issues surrounding the self-insurance funds.

And I think it is quite important that the statement of Ms. Carlisle this morning not go by unchallenged. When she responded to a question from one of the members of the panel to the effect there has been no change in the Treasury's position. In fact, there has been a radical change in their position, and truly I think we all feel betrayed to some degree in that this came without warning and was entirely at odds with all the previous literature that was available from the Service on that question.

There has been quite a good deal made on the question of the administrative cost savings and the claims cost savings that flow from the self-insurers' funds. I think it is important to understand that, while all State workers compensation laws are intended to be self-actuating and that the benefits I think in every care are intended to be prescribed by statute and that there is no intention to set up a litigious environment, it is nevertheless true that there is a broad range of benefits that may or may not be payable and that the claims costs of all the self-insurers funds that I am aware of run substantially below the costs with commercial insurers, and that is one of the major advantages to participating in group workers compensation funds.

It is true that approximately 5 to 10 percent reduction in cost is realized in the administrative area, but the real savings are we believe in the claims cost control area.

Another thing that I think is important to emphasize here and that maybe has not received the full exposition that perhaps it should, and that is that these funds in Florida, and I believe nationwide, have grown up out of a need for business people to comply with their State workers compensation law in whatever State they are operating in.

Almost invariably, these funds grew up first and have grown up largest around industries that the traditional insurance marketplace has turned a deaf ear to. The fund that I work for is the Florida Roofing, Sheet Metal and Air-Conditioning Contractors, and our fund started approximately 35 years ago because roofing contractors simply could not buy workers compensation insurance in the voluntary marketplace.

So it is important to realize that these funds are providing a public benefit in that in many cases the choice may be to go without insurance whatsoever since the insurance companies have consistently turned away from this type of exposure.

And lastly, I would like to emphasize that many of the funds are specialized in one industry segment, and that the safety engineering and loss control efforts that are practiced by these groups often are far superior to what is available from the general insurance marketplace, and indeed, far superior to any of the information and the safety engineering that might be available from, for example, the Occupational Safety and Health Administration.

So we believe that another public policy good is served by the fact that the homogeneity of these funds allows them to focus resources and to reduce the social cost of accidents for their participating members.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF
BRUCE G. MARTIN
FLORIDA ASSOCIATION OF SELF INSURERS

My name is Bruce Martin. I am appearing here as immediate past president of the Florida Association of Self Insurance, an organization of individually self insurance companies, group self insurance funds, and suppliers to self insureds. FASI's individual company members include most "Fortune 500" companies with operations in Florida. These large companies are taxed under the Internal Revenue Code and IRS regulations which are not at issue here.

FASI's self insurance funds contain more than 10,000 small businesses which have banded together to self insure their workers compensation obligations under Florida law.

While these fund participants truly represent a cross-section of Florida's small business community; contractors, subcontractors and agricultural businesses are represented in great numbers. This is no coincidence since these businesses have been traditionally considered poor risks by the insurance industry.

More than thirty years ago, these businesses rebelled at the abuses suffered at the hands of the insurance industry. They determined to band together, pool their resources and take care of their own injured workers. The growth of self insurance funds in Florida is a tribute to the American ideal of voluntarily joining together in groups to solve common problems.

Over the past three years, members of Congress have heard much from their constituents on the devastating effect of the insurance rate increases which have been visited on American business. Not only has the insurance industry charged unconscionable and confiscatory rates for insurance, they have simply refused to write certain kinds of coverages for many businesses.

Congress reacted to this crisis by providing extensive amendments to the Risk Retention Act of 1981. The substance of these 1986 amendments to the Act were to permit businesses to join together to self-insure many types of insurance which have become impossibly expensive or unavailable in the traditional insurance marketplace. It is our opinion that this solution is the best and most appropriate response to the crisis because it lets people help themselves. It is also obvious to us that this solution was at least partially grounded on the success of workers compensation self insurance funds in Florida. We are here today to discuss whether the IRS should be permitted to undo this success.

Contrary to the background information which was provided as part of the notice for this hearing, self insurance funds are not organized as mutual insurance companies. State laws governing mutual insurance companies require substantial capital and retained surplus to organize and operate a mutual insurance company. No self insurance fund we are aware of can qualify under any state law as a mutual insurance company. There is no paid-in capital in a self insurance fund and any funds which are truly surplus to fund needs are returned to fund members.

What is true is that most self insurance funds file Federal tax returns as a mutual insurance company. This is only because this is what the IRS has said should be done. In truth, mutual insurance company tax structure is not a particularly good fit with the organization and objectives of the funds.

It is more useful to think of the funds as a trust, where premiums paid are held under state regulation until they are either paid to injured workers or returned to the members. Many speakers will testify to the importance of the fact that there is no profit motive nor any mechanism to retain wealth in a self insurance fund. They are solely organized for the purpose of providing workers compensation, essentially at cost.

In philosophy and organization, a self insurance fund is similar to the barn-raising agreements in the old west. If neighbors band together to help a homesteader build a barn, does the work and cooperation of the neighbors somehow create a taxable event? We submit that the answer is no. Just because self insurance funds use the modern expedient of cash payments to build a cooperative fund to discharge workers compensation liabilities is no reason for the IRS to assume that there must be a tax liability.

To some extent, IRS cannot see the forest for the trees. Contributions to self insurance funds are taken as deductions by the participating companies during the year in which they are made. If the contributions are not needed to pay claims and are returned to members, they will either be brought into income and taxed, or they will be used to reduce a future year expense, also increasing taxable income. By taxing self insurance funds, there will be a corresponding, and perhaps larger, revenue loss in the taxes collected from the participating members.

We would urge the subcommittee's favorable consideration of Representative Vander Jagt's bill, or any similar remedy which will make it clear that workers compensation self insurance funds should not be taxed.

Mr. **Flippo**. Thank you.
Mr. Ryan?

STATEMENT OF HUGH RYAN, CHAIRMAN, COALITION TO PRESERVE GROUP WORKERS' COMPENSATION FUNDS

Mr. **Ryan**. Thank you, Mr. Chairman and members of the committee. I would also like at this time to thank those of you in attendance this morning and the rest of Congress for in your wisdom adopting the moratorium on the IRS's activities with regard to these funds, and would applaud your efforts at the beginning this morning for seeking a permanent solution to this problem.

The concept of the group workers compensation fund was born of necessity, ingenuity and self-reliance, in our judgment. The first of these funds was established more than 20 years ago originally because small employers could not obtain workers compensation coverage elsewhere. Later on, the funds were established to provide a vehicle for small employers to obtain the same cost advantages of obtaining workers compensation coverage long enjoyed by the large employer.

Virtually from the beginning, these funds have operated under a strict State legislative mandate. The States have generally dictated the manner of organization, the operation, the manner in which we collect premiums, the manner in which we pay claims, and most importantly, the manner in which excess premiums are returned to participating employers.

At the present time some 28 States have enacted legislation that permits groups of employers to join together and establish group self-insured workers compensation funds. This fact alone stands as an ample testimony to the success and effectiveness of the group fund concept. There are some 160 group funds currently operating nationwide. We conservatively estimate that 100,000 employers obtain their workers compensation coverage for their employees from these group funds.

From the beginning, the single business purpose of these funds has been to supply workers compensation coverage at cost to small employers. Consistent with this singular purpose, the funds collect premiums, pay claims and expenses, establish reserves to cover the anticipated costs of losses, and return any excess of these amounts to their member employers.

Why then should these funds be different from private insurers? Why, for example, should they receive tax treatment different from that received by mutual insurance companies?

First, these funds exist for only one purpose, providing workers compensation coverage at cost. Unlike the vast majority of mutual insurance companies, they provide no other form of insurance coverage. In fact, they don't even offer workers compensation coverage in the open market. Typically, their activities are restricted to a single industry within a single State.

Moreover, members of these funds due to entering into a joint and several liability agreement can be assessed for additional funding. To my knowledge, no policyholder of a mutual insurance company is subject to this condition of being a policyholder.

Second, the funds are heavily and severely regulated by the States. Where, for example, one of the primary functions of a mutual insurance company is to actively engage in the investment industry, the funds, by State edict, may only place funds in the most conservative of investment vehicles, which in most cases return rates that barely exceed passbook savings accounts.

And as we have said numerous times, the funds are so heavily regulated by the State that they operate almost as a quasi-State agency. The States see to it that the funds are conservatively funded and operated so that the benefits for injured employees are available when needed.

Perhaps the most important distinction in the funds is that they have proven to be major contributors to good public policy. They help small businesses, the source of the greatest number of new jobs during the past several years in our country, reduce their operating costs through lower premiums. Premiums which frequently are 50 percent lower than those on the prevailing market rates.

At the same time, by reducing these employer costs, they relieve pressure to reduce benefits to injured employees. Simply stated, group funds are unlike any other entity in business.

The group funds need and deserve retrospective relief from potential tax liabilities. For the past 20 years, the funds have relied on prior IRS letter rulings and tax treatment that resulted in the funds as an entity paying no tax. Consequently, the funds have not reserved or otherwise planned for any potential tax liability.

The potential tax liability will, in many cases, exceed the net worth of the affected funds. In such cases, if required to pay the liability, the fund will collapse leaving any remaining financial burdens to be borne by the participating employers who will be assessed for any shortfall. The fact of the matter is that many of the participating employers cannot afford to pay this unanticipated assessment. If assessed, many will literally go out of business, and in the process add their employees to the rolls of the unemployed.

We need prospective relief as well. A judicial resolution is prohibitively expensive and only promises a prolonged period of uncertainty, anxiety and instability. While we wait for justice, the potential tax liability mounts and the legal costs escalate. In the meantime, the funds' members and excess insurers become ever more anxious, concerned and doubtful of the future.

We need to know once and for all what we are from a tax perspective, what procedures we are to follow. For over 20 years, we thought we knew. Now the IRS says the rules have changed.

In summary, we believe that the group fund concept represents some of what is good about America. Many of us at the grassroots saw a problem. We found a solution to the problem by forming group workers compensation funds to relieve unnecessarily and unreasonably high workers compensation costs to small business.

The States have seen the value of this concept and have put into effect appropriate regulatory frameworks to deal with it. H.R. 1709 merely asks Congress to reaffirm the status quo for the group funds and continue without unnecessary intrusion a concept that has consistently contributed to the public good.

Thank you.

Mr. FLIPPO. Thank you, Mr. Ryan.

[The prepared statement follows:]

Hugh Ryan, Chairman
Coalition to Preserve Group Workers' Compensation Funds
TESTIMONY

Mr. Chairman, members of the Sub-Committee. My name is Hugh Ryan. I represent the Coalition to Preserve Group Workers' Compensation Funds which is comprised of the group workers' compensation funds located in some twenty-odd states throughout our nation.

The concept of the "group workers' compensation fund" was born of necessity, ingenuity and self-reliance. The first of these funds was established more than twenty years ago. Originally, the funds were established to provide state mandated workers' compensation coverage for small employers who were unable to obtain coverage elsewhere. Later, additional funds were established to provide a vehicle for small employers to obtain the same cost advantages of self-insuring their workers' compensation coverages--long enjoyed by large employers.

Virtually, from the beginning, these funds have operated under stict state legislative and regulatory mandate. The states have generally dictated the manner of organization, operation, premium collection, claims payment, and most importantly, the manner in which excess premiums are returned to participating employers.

At present, some 28 states have enacted legislation that permits groups of employers to join together and establish group self-insured workers compensation funds. There are 160 such group funds currently operating nationwide. We estimate that in excess of 100,000 employers obtain workers' compensation coverages for their employees from these group funds. While the volume of the workers' compensation coverage represented by employers covered by the funds is very small when compared to the total from all sources, the coverage provided is crucial to the covered employers and their employees. This is true because many of the covered employees would otherwise be unable to obtain coverage from any source and all of them would be unable to obtain workers' compensation coverage at a comparable cost.

From the very beginning, the single business purpose of the funds has been to supply workers' compensation coverage at cost to small employers. Consistent with this singular purpose, the funds collect premiums, pay claims and expenses, establish reserves to cover the anticipated costs of losses--both known and unknown--and return any excess of these amounts to their member employers. All of this is done under strict regulation and oversight by state authorities.

Why are these funds different from private insurers?
Because they have only one purpose: Providing state mandated workers' compensation insurance to small businesses. In addition, these funds provide more effective loss control and worker rehabilitation. Perhaps, most importantly, they have proven to be contributors to good public policy. They help small businesses--the source of the greatest number of new jobs in our economy during the past several years--reduce their operating costs through lower workers' compensation premiums. At the same time, by reducing employer costs, they relieve pressure to reduce benefits for injured workers.

The group funds need and deserve retrospective relief from potential tax liabilities. For the past twenty years, the funds have relied on prior IRS letter rulings and tax treatment that resulted in the funds as an entity paying no tax. Consequently, the funds have not reserved or otherwise planned for any potential tax liability. A potential tax liability will in many cases exceed the net worth of the affected fund.

In such cases, the fund will collapse leaving any ultimate remaining financial burdens to be borne by the participating employers who will be assessed for any shortfall in required funding. The fact of the matter is that many of the participating employers cannot afford to pay an unanticipated assessment. Many will literally go out of business, and in the process, add their employees to the rolls of the unemployed.

We need prospective relief as well. A judicial resolution is prohibitively expensive and only promises a prolonged period of uncertainty, anxiety and instability. While we wait for justice, the potential tax liability mounts and the legal costs escalate. In the meantime, the funds' members and excess insurers become evermore anxious, concerned and doubtful of the future.

We need to know once and for all what we are from a tax perspective and what procedures we are to follow. For twenty years, we thought we knew; now the IRS says the rules have changed.

In summary, we believe the group fund concept represents some of America's strongest attributes. Those of us at the grass roots recognized a problem. The problem was lack of available coverage along with rates that were unnecessarily and unreasonably high for small businesses. We developed a solution called group self-insured workers' compensation funds. State policymakers recognized the value of these funds and established an extensive regulatory framework in order to manage fund operations and financial integrity. In short, the funds are one of those rare creatures that has served for twenty years or more everyone well: small employers, their employees and good public policy.

Through H.R. 1709, we are merely requesting that Congerss reaffirm the status quo for group funds and continue without unnecessary intrusion a concept that has consistently contributed to the public good. Continue a previous IRS practice and policy that resulted in the funds paying no tax.

Mr. **Flippo**. Mr. Martin, you stated that you felt that the insurance cost itself was less for these funds in addition to the savings from administrative costs. Would you elaborate on that? Why would your savings and insurance costs be less than, say, an insurance company or some other?

Mr. **Martin**. There are about three different reasons. The first one is that we are much closer to our customers than an insurance company would be. Our fund, for example, has 400 member firms and we work very closely with our member companies in attempting to put these injured workers back to work as rapidly as possible.

The reason for that cooperation is that these funds, being a cooperative-type of venture, we get good cooperation from the employers where an insurance wouldn't necessarily have that same close working relationship.

The second reason I feel that our actual claims costs are substantially less than the insurers is that we carry a good deal larger number of people to process our claims than an insurer does. As a matter of fact, against industry ratios, we have about twice the number of people processing our claims as an insurance company would. And the reason that we believe in that, it is a pennywise, pound foolish kind of an analysis, where we feel that the additional people are far outweighed by the savings in the claims cost.

Mr. **Flippo**. Thank you very much.

Mr. Ryan, you seem to be saying that the self-insurance firms are different from mutual insurance companies in that primarily you are a limited purpose. You are in a very limited area of providing this service, and that, therefore, this distinction in the public importance of the service that you render is sufficient to distinguish you from a mutual. Is that a fair statement of your position?

Mr. **Ryan**. Yes, it is.

Mr. **Flippo**. Well, let me ask, then, Ms. Etkin, I believe you are tax counsel?

Ms. **Etkin**. Yes.

Mr. **Flippo**. Could not a mutual insurance company simply have a spin-off for a limited purpose in workmens' compensation? If we grant a full 501(c)(3) exemption, what would prevent an insurance company from, say, spinning off only its workmens' comp? If you were advising them, what would you advise a mutual insurance company to do, if we grant this full tax exemption?

Ms. **Etkin**. Well, I think there are two answers to that. One is that the States regulate these entities in a much stricter fashion than mutual companies are regulated. I think that State regulation would effectively prevent a mutual insurance company from spinning off an entity.

First of all, at least in Michigan, these funds can be comprised only of companies that are in the same industry group. They have to have the same types of risks to pull together to be a fund, so there is a practical limitation. The regulations wouldn't permit it.

There is another reason which has to do with why, perhaps, a company would choose to pay a slightly higher cost or a considerably higher cost to go with a mutual company versus being in one of these funds; and that is, that every member of these funds have joint and several liability for the claims of every other member in the fund.

Now if things go well, which they have for most of these funds, there is really no effect to joint and several liability. It is a risk. However, this tax bill, the notice of deficiency that the Detroit Tooling Association has, really highlights the risks of joint and several liability. A company is taking a risk by entering into one of these funds. The benefit is that they pay a lower premium and they get their money back quickly, but there is a risk.

Mr. FLIPPO. I see. All right.

Mr. Vander Jagt?

Mr. VANDER JAGT. Thank you very much, Mr. Chairman. And thank you, members of the panel, for your very helpful comments this morning.

Mr. Moore, you enlightened me. I have always thought of this proposed legislation as a jobs bill, and that if small businesses can't continue, jobs will be lost. But you have enlightened me. It is a trade bill, too. The tooling industry is helped to be competitive.

You stated that you give refunds every year, that is, you give a portion of the premiums back. Does somebody pay tax on the refund?

Mr. MOORE. Absolutely.

Mr. VANDER JAGT. Are you now involved in a lawsuit with the IRS?

Mr. MOORE. Yes, sir.

Mr. VANDER JAGT. Has a trial date been set?

Mr. MOORE. No, sir. The moratorium put a stop to that.

Mr. VANDER JAGT. I understand that the IRS has also not pushed for a trial date because they are reevaluating their position?

Mr. MOORE. That is correct. We have met with the chief tax counsel and his staff. We have also met with the Detroit district director in attempting to resolve this matter outside of this room.

Mr. VANDER JAGT. How much of a deficiency is hanging over your head now?

Mr. MOORE. 18,254,000 and some odd dollars.

Mr. VANDER JAGT. What would it do to your organization if the deficiency stood?

Mr. MOORE. Well, considering that we only have a couple of million dollars that would be unallocated surplus, and that is only because the State will not permit us right now to give this back because of the deficiency, I would assume, that they would come in, take our $2 million, take our reserves for our known claims, the claims that we are paying our employees with, take that money and that amounts to approximately $6 million that we are paying in claims. Last year alone we paid out $6,200,000 to over 7,600 claimants.

Then they would have to, under the joint and several liability agreements signed by all members, and this is true for all the funds that I know of nationwide—they would then go in and assess the membership. The weaker ones would fall because they would have very little cash available. They would have to collapse immediately because they would not have their share of the assessment, and that share of the assessment would go on to the stronger, better heeled companies, and they, too, would have difficulty coming up with $18 million.

Now meantime, no one is paying our claims. So the State of Michigan would have to come in under State law and start paying our claims. Now we have an attachment point on our reinsurance. All funds have reinsurance policies. We have to exceed $10 million. So I would again think that the State would have to pay our claims up to the $10 million for that given year, and then the reinsurance companies would come in.

So the State would be out millions of dollars and we would be out of business.

Mr. VANDER JAGT. It would be a mess all the way around——

Mr. STARK. Would the distinguished gentleman from Michigan yield, please?

Mr. VANDER JAGT. Of course.

Mr. STARK. I wonder if I could inquire of the gentleman from Michigan if I might not raise his comfort level by several degrees if I suggested that there are two issues before us, and one of the two I think I would agree with the gentleman.

We are talking about some retroactive penalties of great amounts here which affect some States more than others and in some amounts more than others. And as the gentleman from Michigan knows, I have never been one to either provide benefits retroactively or go after penalties retroactively, and that might make the people from Michigan——

Mr. VANDER JAGT. I would say to the gentleman, that does make me feel more comfortable.

Mr. STARK. Be a great deal more comfortable.

But secondly, the second issue that I think we then must address, and I think maybe the gentleman would say that we have an area here that we might look at together. If, indeed, prospectively we are to give certain tax advantages to certain organizations or forms of organizations, I don't care whether it is a farmers co-op, be it Sun-Kist or the great co-ops from the State of Michigan and Minnesota, or whether it is a mutual insurance company or workmen's comp, we have some obligation to provide uniform benefits for those Federal funds.

For example, I think the gentleman would understand that Michigan I believe requires that all employees are covered. California does the same. Alabama, I think if you have less than three you are exempt. It could well be that we would have to negotiate with our distinguished chairman and see what we could do and whether that might be worth it for Alabama to subscribe to benefits standards as we do under VEBA.

So if, in fact, we could look at this problem as bifurcated as it were, say let us deal with the retrospective issue and perhaps find a way to resolve that, and then prospectively say what is the proper way to go forward from here, and make sure that a whole lot of new companies don't jump into any tax relief we might give.

I think this gentleman could enthusiastically work in a spirit of compromise with the gentleman from Michigan and our chairman from Alabama if that might be a resolution.

Mr. VANDER JAGT. I would say to the gentleman from California that I am somewhat comforted, knowing that the gentleman is reluctant to have any retroactive imposition of penalties or deficiencies. I think that should clearly be the ground rule until this change in IRS policy is clearly established. Do you agree, Ms. Etkin?

Ms. ETKIN. Yes.

Mr. VANDER JAGT. When the IRS has conducted audits in the 20 years prior to the change, would it not use that ground rule?

Ms. ETKIN. I would assume so.

Mr. VANDER JAGT. Whereas everyone knows that the IRS can change its policies inasmuch as they do it all the time, with or without congressional approval, any change is usually predicated on some change in a legislative signal or in the practice of the groups that are being audited.

Do you know of any change in the legislative picture or any change in the way the funds were being conducted that prompted the change?

Ms. ETKIN. I am aware of no change either legislatively or in terms of their operations.

Mr. VANDER JAGT. Thank you.

Mr. Martin, you have helped us by your experience in the roofing business. That the genesis of these funds oftentimes were that no private insurance was available, and that it is, as Mr. Ryan said, America at its best. A group of individuals pooling their resources to solve a problem that no one of them could solve alone.

And, Mr. Ryan, you thanked this committee and the Congress for providing a moratorium while all of this can be worked out to some sort of permanent solution. Has the moratorium stopped the audits?

Mr. RYAN. Well, as a matter of fact, they have not.

Mr. VANDER JAGT. You mean that in spite of congressional passage of a moratorium effective until September of this year that the audits have continued?

Mr. RYAN. That is correct, Mr. Congressman. Apparently the IRS has a much more narrower view of the meaning of the moratorium and has reactivated all of the audits that they had commenced in Michigan prior to the adoption of the moratorium, and, in fact, has issued another letter of deficiency to an additional fund in Michigan for an amount that exceeds the total assets of that fund by more than $300,000.

Mr. VANDER JAGT. As I understand it, the IRS continues with audits despite a congressional moratorium through some very narrow interpretation of the law by not questioning any longer whether the funds are mutual companies.

Mr. RYAN. That is correct. What they have simply done in order to sidestep what we perceive to be the will of Congress is to drop the issue of whether or not the funds are mutual insurance companies, and thereby they have sidestepped the moratorium and have continued their audit procedures.

As the prime author of a moratorium and the Tax Reform Act of 1986, I can assure you that I was not thinking of any narrow definition of whether they could look at the definition of mutual companies. I intended it to stop all audits until together we could resolve this issue.

One last question, Mr. Ryan. I have made the statement and others have made the statement that if the IRS position prevails that many of these funds will be forced to terminate, leaving the former participants without a viable source of workmen's compensation and causing some businesses to no longer continue in business and to go out of business.

Others say that is very exaggerated. Can you cite for this subcommittee any specific situations where that would happen if the IRS position prevailed 100 percent? I think Mr. Moore has already given us some clue as to——

Mr. RYAN. I think probably that—I could not cite a specific business not knowing the financial conditions of each of the specific businesses, but certainly there are industries in our State that operate under such competitive pressure at this stage in their evolution and have such a very narrow margin of financial stability that if they were assessed to reconstitute the reserves of a fund in which they participated in, many of them could very well go out of business.

I think it is important to bear in mind that we are talking about mandated coverage here, and it is not uncommon in our State for individual businesses in some cases to have gone out of business because they could not obtain coverage from the private sector, they could not obtain coverage from the commercial insurance market, they did not have enough financial reserves of their own to self-insure, there was not a workers comp fund available for them to obtain the coverage, and many of them went out of business because the State mandates that they have coverage and they were not otherwise able to obtain it.

So while we couldn't cite a specific example of a business simply because we wouldn't have access to that kind of specific information, we have reason to believe that could be one of the eventualities.

Mr. VANDER JAGT. Your answer is that a business may go out of business where insurance is mandated by State law, if it cannot obtain insurance privately or can't afford insurance privately?

Mr. RYAN. Exactly.

Mr. VANDER JAGT. There is no question in your mind that would happen in some instances in the State of Michigan?

Mr. RYAN. No question.

Mr. VANDER JAGT. Thank you. I again thank each member of the panel.

Thank you, Mr. Chairman.

Mr. FLIPPO. Thank you.

Another distinguished gentleman from Michigan, Mr. Levin.

Mr. LEVIN. Very briefly to my colleague from Michigan, I join him in finding heartening the response of the gentleman from California to your initiative to put a hold on this and his indication that retroactive application has some deep inequity in it.

But I, to my colleagues from Alabama and Michigan, would just say as a nonmember of this committee, again my appreciation for being able to sit in so far, and also to say as to the future it is my own reaction that to try to build in Federal standards to any different treatment has some real peril.

I think the more fruitful way may be to answer the question directly how does this kind of a fund differ from a mutual insurance company. Should there be separate tax treatment in this instance? And is it really justifiable in terms of sound tax policy?

The gentleman from Alabama has hit very much at this issue, and I think effectively. And the funds and their attorneys I think need to provide to this subcommittee and the full committee and the Congress guidance and inputs on this.

And also, on the other hand, if it were treated differently than a mutual insurance company, would it be fair to the individual self-insured employer?

My own feeling, and I am rather new to this, though not necessarily to the workers comp field, that this is really kind of cash in and cash out, and there is investment only because you don't want to have funds lie fallow. But there is no investment purpose here at all, and that the only reason the money isn't given back immediately is because the State regulators want to take a look to make sure there are adequate reserves.

And if that is true, the question is should that be treated the same as a mutual insurance company?

Thank you, Mr. Chairman, very much.

Mr. FLIPPO. Thank you.

We thank our panel very much for very useful information.

Our next and final panel, we have three individuals. First, we have Mr. John Nolan, who is counsel for the Accident Fund of Michigan, a recognized expert in the tax area; Mr. Thomas Stahl, executive vice president of the Florida Group Risk Administrators Association of Tallahassee; and Mr. Peter Grieves, executive director of the Michigan Association of Timbermen, Newberry, Mich.

We thank our panelists for joining us. You have heard the previous testimony. You know, of course, your testimony will be included in its entirety, and we would ask that you summarize, and proceed as you deem appropriate.

Mr. Nolan.

STATEMENT OF JOHN S. NOLAN, COUNSEL, ACCIDENT FUND OF MICHIGAN

Mr. NOLAN. Thank you, Mr. Chairman, members of the subcommittee. My name is John S. Nolan, and I appear today on behalf of the Accident Fund of Michigan, which is the type of State fund to which Mr. Stark referred earlier and which provides insurance to cover workers compensation claims against Michigan employers.

Most of the employers that are insured through the Michigan fund are small business concerns. I appear today to urge that any legislation in this area clarify the treatment of State workers compensation funds and similar State-sponsored funds as well. For example, Michigan has not only a State-sponsored workers compensation fund but also has State-sponsored funds designated the Silicosis and Dust and Disease Fund, the Second Injury Fund, and the Self-Insurers Security Fund, which provide similar State-sponsored coverage.

State workers compensation funds have a long history which dates back to the early 1900s. The Michigan fund was created in

1912. When State laws were enacted imposing upon employers absolute liability to workers for compensation for injuries incurred on the job, it readily became apparent that means had to be provided to fund this liability to protect both the workers and the employers. Employers needed a way to spread the risk through insurance.

In those early days, it was entirely uncertain whether commercial insurance would be provided for this purpose because absolute liability was a new concept in the law at that time. Accordingly, State-sponsored funds to provide this funding and insurance were created to meet this need. Accordingly, the creation of these State funds was a direct result of statutes which imposed absolute liability on employers.

Today, there are 19 States which sponsor some kind of State accident fund to provide assurance to workers that there will be funds available to pay their claims. In two States, employers are required to purchase insurance from the State fund and they have no other option. In four other States, the employer may purchase insurance from the State fund or may self-insure if the employer satisfies specified financial criteria. In 13 other States, including Michigan, the employer may purchase insurance from the State fund, may self-insure if specified financial criteria are met, or may purchase insurance from a commercial insurance company.

After these laws were passed, some commercial insurers began to offer workers compensation insurance to employers, but on a very selective basis. Even today, some of the State-sponsored funds provide coverage that is not readily available from commercial insurers.

About 75 percent of the business of the Michigan fund is with small businesses such as taxi drivers or small taxi companies, mom and pop grocery stores, small contractors doing remodeling work, and similar small businesses.

As I have said, there are also in Michigan other State funds: the Silicosis, Dust and Disease Fund, the Second Injury Fund, and the Self-Insurers Fund. As you see, where a new kind of liability has been imposed upon employers in the early 1900s, representing a new concept in the law, it has been entirely unclear whether commercial insurance would be provided. In areas like silicosis and dust disease the commercial insurers simply have not been interested in providing that kind of insurance. So the State steps in, sponsors the fund, and the State activity provides this necessary insurance to the employers.

This history demonstrates that State workers compensation funds have historically been a function of the States' exercise of their constitutional grant of police powers to provide effective, funded protection for workers against job-related injuries.

With the growing availability of commercial workers compensation insurance, however, it is not entirely clear what the Federal tax status of these State funds is to be. When an exemption from State income tax rests, as it does here, on constitutional principles, there is a degree of doubt as to the Federal tax status because the U.S. Constitution is not written into the Internal Revenue agent's manual. The Internal Revenue Service is not generally equipped to deal with questions of tax liability that are at the constitutional level.

These State-sponsored funds have generally been operated pursuant to the enabling State legislation as nonprofit organizations. They return their excess funds to the policyholders as policyholder dividends. At the same time as business activities have expanded over the years, and the risks of injury have increased with increasing industrialization, some of the premium income has been retained by these to build State fund surpluses to levels that are considered necessary and safe by State regulatory authorities, according to well-accepted standards of financial responsibility.

These State funds have viewed themselves as engaged in the exercise of essential State governmental functions. They have viewed themselves as constitutionally immune from Federal taxation. It is for this reason that I urge that this occasion be taken to clarify the tax status of these State-sponsored funds as tax exempt, also with retroactive effect. In view of their long history of public service, I suggest that they are even more clearly entitled to tax exemption for past years and future years as well.

I note in closing that this is not a case of unfair competition with respect to commercial insurance companies. For the most part, these State funds, and to a large extent the pooled funds, provide insurance to employers that the commercial companies simply do not find attractive to provide.

The States, in sponsoring these State funds have simply filled a necessary void. They have exercised their constitutional police power in sponsoring these funds. Having imposed absolute liability on employers, this is a State function, and these State funds clearly ought to be made tax exempt.

Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN S. NOLAN
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
WAYS & MEANS COMMITTEE, U.S. HOUSE OF REPRESENTATIVES
APRIL 7, 1987

TAX TREATMENT OF WORKERS COMPENSATION FUNDS

My name is John S. Nolan, and I appear today on behalf of the Accident Fund of Michigan (AFOM), a state-sponsored workers compensation fund to provide insurance to cover workers compensation claims against Michigan employers. Most of such employers insuring through AFOM are small business concerns.

I appear in support of Mr. Vander Jagt's bill, H.R. 1489,[1] to provide tax exemption to certain workers compensation funds. I appear in particular to urge that this legislation clarify the treatment of state workers compensation and similar state-sponsored funds as well.

State workers compensation funds have a long history dating back to the early 1900's. It was in this early period (1911) that state laws were first enacted imposing upon employers absolute liability to workers for compensation for injuries incurred on the job. It readily became apparent that means had to be provided to fund this liability to protect both the workers and the employers. Employers needed a way to spread the risk through insurance. State-sponsored funds to provide this funding and insurance were created to meet the need. Thus, the creation of these state funds was a direct result of statutes imposing such absolute liability on employers, as will be evident from a brief summary of the origins of workers compensation.

At common law, an employee injured on the job could recover compensation or damages from the employer only by proving that the employer was negligent, that the employee had not been guilty of contributory negligence, and that the employee should not be deemed to have "assumed the risk" of injury by accepting the employment. It proved virtually impossible for workers in the nineteenth century in Great Britain and the United States to recover compensation for their injuries under these rigid common law standards.

At the time of the turn of the century, public opinion became strongly aroused as the peak of industrial injury rates occurred in the years 1900-1910. Statesmen, such as Theodore Roosevelt, led the charge for state laws imposing absolute liability upon employers. Some of these early state laws were held unconstitutional, but in 1917 the U.S. Supreme Court held that such laws were constitutional based on the police powers of the states.[2] Thereafter, in the United States, Great Britain, and many other countries, workers compensation laws were among the first types of social security legislation to be enacted.

As previously stated, it quickly became apparent that employers needed some opportunity to spread the risk of such absolute liability to provide assurance to workers and themselves that such liability would be funded. It was not at all clear that commercial insurers would write this type of coverage. In Great Britain, a governmental committee undertook to explore creation of a system of accident insurance under the control or supervision of the state. In the United States, several states, notably Michigan in 1912, made statutory provision for a state-sponsored fund from which employers could purchase insurance against such risks.

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[1] H.R. 1709 is identical to H.R. 1489 but is sponsored by fifteen other members.

[2] New York C.R. Co. v. White, 243 U.S. 188 (1917).

Today there are nineteen states which sponsor some form of state accident fund to provide assurance to workers that there will be funds available to pay their claims. In two states,[3] employers are required to purchase insurance from the state fund; they have no other option. In four other states,[4] the employer may purchase insurance from the state fund or may self-insure if the employer satisfies specified financial criteria. In thirteen states, the employer may purchase insurance form the state fund, may self-insure if specified financial criteria are met, or may purchase insurance from a commercial insurance company.[5]

Shortly after these laws were passed some commercial insurers began to offer workers compensation insurance to employers. Even today, some of the state-sponsored funds provide coverage that is not readily available from commercial insurers. For example, approximately seventy-five percent of the business of AFOM is with small businesses, such as small contractors, "mom and pop" retail stores and restaurants, and taxi drivers. Indeed, AFOM writes more taxi company business than any other insurer in the State of Michigan.

This history demonstrates that state workers compensation funds have historically been a function of the states' exercise of their constitutional grant of police powers to provide effective, funded protection for workers against job-related injuries. With the growing availability of commercial workers compensation insurance, questions have been raised as to the federal income tax status of these state funds.

State-sponsored funds have generally been operated, pursuant to their enabling state legislation, as non-profit organizations, returning their excess funds to policyholders as policyholder dividends.[6] At the same time, as business activities have expanded over the years, and the risks of injury have increased with increasing industrialization, some of their premium income has been used to build their surpluses to levels considered necessary and safe by state insurance regulatory authorities, according to well-accepted standards of financial responsibility.[7]

These state funds have viewed themselves as having engaged in the exercise of essential state governmental functions. They have viewed themselves as constitutionally immune from federal taxation. As commercial insurance has become increasingly available, however, this position has become less certain.

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[3] North Dakota and Wyoming.

[4] Nevada, Ohio, Washington and West Virginia.

[5] Arizona, California, Colorado, Idaho, Maryland, Michigan, Minnesota, Montana, New York, Oklahoma, Oregon, Pennsylvania, and Utah.

[6] The provisions of the Michigan statute, enacted in 1912, are attached as an example as Appendix 1. Note that § 711 provides that the accident fund shall be neither more nor less than self-supporting. Similar provisions exist in enabling legislation of other states.

[7] For example, as a general rule of thumb, the ratio of written premiums to surplus should be 2 to 1 for so-called long-tail business such as workers compensation in which claims are often resolved many years after the year in which the accident occurs.

Section 1879(q) of the Tax Reform Act of 1986 placed a one-year moratorium on Internal Revenue Service audits of pooled self-insurance funds established by unions, trade associations, or other employer or worker groups. These pooled funds have generally been organized similar to mutual property and casualty insurance companies. The IRS has questioned the classification of such funds as mutual property and casualty insurance companies, which, at least until the Tax Reform Act of 1986, have been entitled to favorable federal income tax treatment. The IRS has also questioned the timing and allowance of deductions for policyholder dividends paid by such funds.

Mr. Vander Jagt's bill, H.R. 1489, seeks to end these disputes by granting tax exempt status to these pooled self-insurance funds under appropriate conditions, with retroactive effect. In view of the strong social policy supporting the existence of such funds, tax exemption under certain conditions is entirely justified.

I urge that this occasion also be taken to clarify the status of state-sponsored workers compensation funds as tax-exempt, also with retroactive effect. In view of their long history of public service, they are even more clearly entitled to tax exemption for past years and future years as well.

This is not a case of unfair competition with respect to commercial insurance companies. For the most part, the pooled self-insured funds and the state-sponsored funds provide insurance to employers that the commercial companies do not find particularly attractive.

Accordingly, I respectfully urge that legislation be enacted treating state workers compensation and similar accident funds[8] as tax-exempt organizations for past and future years.

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[8] For example, the following state funds in Michigan should be similarly treated: The Second Injury Fund, The Self-Insurers Security Fund, and The Silicosis, Dust Disease, and Logging Industry Compensation Fund.

Chairman RANGEL. Mr. Stahl.

STATEMENT OF THOMAS W. STAHL, EXECUTIVE VICE PRESIDENT, FLORIDA GROUP RISK ADMINISTRATORS ASSOCIATION

Mr. STAHL. Thank you, Mr. Chairman, and members of the committee. I will be very brief. I realize we are well into the lunch hour. I think one of the issues that the Service has brought out and from the questions raised by the members is how are we different? We seem to look and smell an awful lot like a mutual company, and, therefore, we ought to be treated like a mutual company.

There are some fundamental differences both in our formation and the way we operate. We don't have capital. We don't have that capital to fall back on in bad years. A mutual company can pay dividends out of their retained earnings. We don't have any retained earnings. Mutual companies in Florida, at least, and probably nationwide, are allowed to make investments in certain things that we are not allowed to invest in. We are not allowed to invest in the stock market. We are not allowed to invest in real property. We don't build office buildings. By and large, we are allowed to invest in CDs and very stable investments.

The key distinguishing factor, and I think everybody has danced around it somewhat, is we don't have any net income. And I am not a tax attorney, but I have naively been told that in order to have taxes you have got to have some taxable income. Nowhere in the self-insurance funds are there any taxable income. Everything is returned back to the members after appropriate amounts are reserved and claims are paid and expenses. We don't have any taxable income at the end of a fund year; therefore, that is why we have never paid income taxes historically.

With due respect to the insurance industry lobbyists, who are apparently not here today, we hear a lot of arguments about the level playing field. We are not in the same field. In my experience in Florida we hear the level playing field argument all the time from the insurance industry. Their idea of a level playing field is apparently when they own the field, they own both teams, they own the bats, the balls—that is their idea of a level playing field. We are not on the same field. We are fundamentally different from the insurance companies.

I think that you have already heard ample testimony as to why we are providing available coverage that would not otherwise be provided by the insurance companies. We do typically provide coverage to small employers. The association I represent is made up of other trade associations such as the homebuilders, the automobile dealers, but by and large these are small businesses. These are the people who are going to be affected by any legislation proposed by Congress. It is essential I think that we get some type of a road map from Congress as to what the tax treatment should be of these funds. We have operated, historically, for many years, have never had any problem from the Service, and now apparently the Service has reversed itself, and I think it is important that we get some type of a road map as to how we should be treated.

And I thank you.

[The prepared statement follows:]

Written testimony of
Thomas W. Stahl
Executive Vice-President
Florida Group Risk Administrators Association (GRA)

I. Introduction

My name is Tom Stahl and I am the Executive Vice President of the Florida Group Risk Administrators Association ("GRA"). GRA is a non-profit trade association which represents the interests of group self-insurance funds in Florida. Our membership includes self-insured workers' compensation funds, health benefit trusts, and commercial self-insurance funds which provide property and casualty insurance, including liability coverage, to Florida employers.

On behalf of GRA and the more than 24,000 Florida employers who participate in group self-insurance funds, I would like to express our concerns regarding a dispute between the Internal Revenue Service and group self-insurance funds in Michigan.

II. Group Self-Insurance Funds in Florida

Florida is the national leader in the creation and operation of the group self-insurance concept. Florida was one of the first states in the country to allow employers to pool their workers' compensation risks in group self-insurance funds and Florida continues to be a leader and innovator in the operation and regulation of self-insurance funds. The self-insurance laws and regulations developed and implemented in Florida are often used as models by other states which allow group self-insurance. Florida is a recognized leader not only in self-insured workers' compensation funds, but also in other areas of business insurance, such as self-insured health benefit funds. Last year, Florida once again led the nation by becoming the first state to allow the formation of commercial self-insurance funds authorized to write commercial liability and property/casualty insurance.

The oldest workers' compensation fund in Florida has been in existence for more than 35 years and Florida has several funds which have been providing coverage for over 20 years. Self-insurance funds have a proven record of providing solvent and stable workers' compensation coverage to the employers and employees of Florida, with the result that today more than 24,000 Florida employers participate in self-insured workers' compensation funds. In 1986, the annual premium for self-insured workers' compensation funds in Florida was more than $275 million. More than 20% of the employers in Florida currently participate in group self-insurance funds and more than one million Florida employees are provided with protection for their work-related injuries. It should be noted that not a single self-insurance fund in Florida has ever failed to deliver benefits to an injured employee.

Self-insurance funds provide two important functions for employers: stability in the workers' compensation market and competition for the commercial insurance industry. Self-insurance funds, owned and operated by member policyholders, have provided a viable market, year-in, year-out, to employers who are required by law to guarantee the payment of workers' compensation benefits to their employees. Self-insurance funds are often the only market for certain employers because of the reluctance by the commercial insurance industry to write workers' compensation insurance for small businesses. Self-insurance funds, operating as non-profit entities, have been able to provide insurance coverage at the lowest possible cost, which in turn has provided price competition and an alternative to the commercial insurance industry. Florida has enjoyed a relatively stable price structure for workers' compensation coverage for many years, due in large part to the successful competition provided by group self-insurance funds.

III. Operation of Group Self-Insurance Funds

Group self-insurance funds in Florida, and in most other states, operate as non-profit trusts. By law, self-insurance funds in Florida are unincorporated associations which exist solely to provide workers' compensation coverage to the member policyholders of the fund. The members in a given fund are required to have common interests and typically are in similar or related businesses, such as the construction industry or the hotel/motel industry. Group self-insurance funds provide an opportunity for employers with common business characteristics and common risks to pool their liabilities and spread the risk of a given loss over all of the members in the fund.

Self-insurance funds operate under the direction of a board of trustees, who are elected by the members of the fund. The trustees are responsible for the overall management of the fund, including setting the rates to be charged to fund members, the payment of claims and expenses, and the return of any surplus back to the fund members. It is this return of surplus back to the fund members which is the key element distinguishing non-profit self-insurance funds from profit-making insurance companies. The return of surplus back to fund members serves to decrease the cost of insurance to fund members and allows funds to provide coverage at the lowest possible cost. As will be discussed below, this return of surplus is at the heart of the current dispute in Michigan between the Internal Revenue Service and self-insurance funds.

In Florida, group self-insurance funds collect premiums from fund members, pay claims as they become due, and set aside moneys (reserves) for future claims. The premiums, expenses, claims, and reserves are required by Florida law to be accounted for on fund-year basis. That is, each year is independent of all other years. The losses from one bad year cannot be made up from the gains made during a good year. Members of a self-insurance fund agree to be jointly and severally liable for the obligations of the fund and if claims and expenses exceed the premiums collected in a given year, fund members are subject to assessments to make up the deficit.

After the end of a given fund year the trustees review the claims paid and set aside (reserve) the amounts needed to pay claims incurred during the year but which are not yet due. Any surplus amounts remaining after the payment of expenses are then ordered by the trustees to be refunded back to the fund members in the form of dividends or return of surplus. In Florida, state regulations prohibit the return of surplus until at least 12 months after the end of a given fund year and then only after the fund obtains prior approval from the state regulator. This 12-month waiting period is considered to be essential to the solvency of the fund in that the waiting period allows all claims to fully mature and develop prior to the distribution of any fund surplus. Since group self-insurance funds do not have a cushion of paid-in capital to protect against unexpected losses, the 12-month waiting period ensures that the self-insurance fund will have the money needed to pay claims as they become due. This waiting period prior to the distribution of surplus is therefore essential to the continued solvency of the fund.

After the payment of all claims and expenses and the proper funding of reserves, and after obtaining approval from the state, the trustees distribute the surplus back to the fund members in the form of dividends. The dividends are considered taxable income to the member policyholders. Since the fund does not retain any amounts in excess of those required to pay future claims, the fund does not have any net income at the end of the year.

IV. Tax Treatment of Group Self-Insurance Funds

In light of the fact that group self-insurance funds return all surplus moneys back to the member policyholders and do not earn net income, the Internal Revenue Service has historically treated funds as non-profit entities. Most funds in Florida file tax returns as either mutual insurance companies or stock insurance companies which earn no net income. The filing of income tax returns in this manner by group self-insurance funds in Florida has never been questioned or rejected by the Internal Revenue Service.

As I am sure the Committee is aware, the IRS has recently disallowed the deduction taken by several self-insurance funds in Michigan for surplus moneys being returned to fund members as dividends. Until the IRS began auditing group workers' compensation funds in Michigan in 1985, the IRS had routinely allowed self-insurance funds to claim a deduction on the fund's tax return for those amounts allocated as surplus to be returned to policyholders, i.e., the IRS has always allowed self-insurance funds to claim a deduction for dividends to be paid to fund members. The IRS has routinely recognized the requirement of Florida law that self-insurance funds must wait at least 12 months following the close of a fund year before distributing dividends or surplus to policyholders. In fact, the IRS has issued at least one private letter ruling to a Florida self-insurance fund stating that the fund could claim a deduction on its federal income tax return for the return of policyholder surplus even though Florida law requires the fund to withhold the distribution of dividends for at least 12 months following the close of the fund year. The IRS has consistently, since the inception of self-insurance funds in Florida, taken the position that self-insurance funds are not subject to federal taxation because self-insurance funds do not earn taxable income. The IRS's long-standing position is consistent with the fact that self-insurance funds do not accumulate wealth or retain net earnings. Self-insurance funds do not accumulate taxable net income because there are no earnings -- all moneys not needed to pay claims and expenses are returned to policyholders.

The IRS has apparently now reversed itself and is taking the position in Michigan that self-isurance funds are in fact profit-making insurance companies. This complete reversal of the tax treatment of group self-insurance funds has no basis in law or in practice. Self-insurance funds are operated as non-profit trusts for the benefit of the fund members, who are also policyholders. There are no stockholders, there is no equity, and there is no taxable income.

If the IRS is successful in its attempt to levy income taxes against self-insurance funds in Michigan, the IRS will presumably also attempt to tax self-insurance funds in Florida and other states. The levy of income taxes against self-insurance funds will effectively destroy the entire concept of self-insurance. The main assets of self-insurance funds are the reserves which have been set aside to pay future claims. If the IRS seizes those reserves for payment of taxes allegedly due, there will be no moneys to pay claims. Since the fund members are jointly and severally liable for the payment of claims, the fund members would be subject to assessments for the payment of those claims. Most fund members are small businesses and the assessments to pay for outstanding claims would put many members out of business. Not only would the business of the member policyholders be seriously jeopardized by the IRS's seizure of fund assets, the claims being paid to injured workers would also be disrupted, causing untold hardship to those employees who depend on self-insurance funds for the payment of their lost wages and medical expenses. In short, the taxation of self-insurance funds would destroy the viability and solvency of existing self-insurance funds and would preclude any new funds from ever being formed.

IV. Florida Employers Support HR 1489/1709

The IRS's recent attack on Michigan self-insurance funds has caused tremendous uncertainty as to the proper tax treatment of group self-insurance funds. In order to resolve this uncertainty, it is essential that self-insurance funds be provided with a clear roadmap as to their status under the Tax Code. Towards that end, GRA and the Florida employers who purchase workers' compensation coverage from member-owned self-insurance funds support the solution contained in HR 1489/1709 introduced by Representative Guy Vander Jagt. The proposed legislation clarifies the proper tax treatment of group self-insurance funds and provides clear guidelines for self-insurance funds to retain their non-profit status. HR 1489/1709 will not decrease federal revenues because self-insurance funds have historically never paid income taxes due to the fact that they have never accumulated taxable income. When surplus, in the form of dividends, is returned to member policyholders, the surplus is taxable income to that policyholder and taxes are paid at that time; HR 1489/1709 will not reduce the taxes currently being paid on those dividends. The legislation is revenue-neutral because it simply clarifies the manner in which the IRS has historically treated group self-insurance funds.

Because of the importance of group self-insurance funds to the employers and employees of Florida, I respectfully urge you to give favorable consideration to HR 1489/1709.

Chairman RANGEL. Mr. Grieves.

STATEMENT OF PETER C. GRIEVES, EXECUTIVE DIRECTOR, MICHIGAN ASSOCIATION OF TIMBERMEN, NEWBERRY, MI

Mr. GRIEVES. Thank you, Mr. Chairman. I would like to thank you and your committee for taking valuable time to hear our concerns.

I was one of seven people who helped establish the first self-insuring fund in the State of Michigan. Our members are loggers and sawmill owners, and at that time we did not have workers compensation insurance. Fortune 500 companies encouraged a large mutual to come in and provide on a group safety basis insurance for all our members or what were to become our prospective members.

That mutual insurance option just simply did not work. They did not provide safety. They did not provide competitive insurance premiums that could be afforded. They were charging insurance premiums that were to grow to $44 a premium for every $100 of payroll. And some people don't quite understand what that means, but that is 44 percent for work comp premium or $44 of premium for each $100 of payroll.

In 1974, we were able to persuade the State legislature that we should look at a self-insuring fund option. What you have in a self-insuring fund is peer pressure from one businessman talking to another businessman: Do you want to go back to the way we used to have to do business and buy insurance from the insurance industry? So peer pressure is important.

I think you realize what is very important is that you try to have no workers compensation expense. You will have no workers compensation expense if you have no injuries. So the key to an effective self-insuring program is to prevent injuries. Self-insuring funds are committed to produce a safer working place. I will submit that as a very valuable public policy.

Self-insuring funds, once injury occurs, support effective rehabilitation and return-to-work. And again, I submit that is a worthy public policy. Employers and employees alike work together when you have a small self-insuring fund.

Much has been said about the level playing field. Is this what we want, where you have a level playing field by increasing the cost on innovative programs such as ours? Increasing the cost to make us level? That doesn't seem to make sense in a day when we want to make ourselves more competitive.

The solution to this problem is not turning to private bureaucracies such as insurance companies. It is not turning to public bureaucracies such as State run-insuring funds. Nor is it turning self-insuring funds, ourselves, into one of those ineffective bureaucracies.

We must grasp the efficiencies and the common sense that is developed through these programs by the small business community. The small business community has produced a solution that works. When something works don't attempt to fix it. I come from 30 miles south of Lake Superior. We still have some rarefied air up there where common sense has a valuable role to play.

I would like to conclude with my last three paragraphs of my written statement. I would submit that the United States must do everything possible to remain competitive in the work marketplace in all segments of business and industry. Innovations in reducing insurance costs while producing a more safe work environment should be encouraged, not taxed out of existence by a zealous tax-collecting agency. Our members are small businesses without administrative staffs to fight and resist the number of regulations that they are faced with every year.

Our small business members are the foundation of Michigan's forest products industries, just as small businesses are the backbone of the entire United States economy. Neither the State of Michigan nor the United States can afford to see a $4 billion industry, which ours is in Michigan, threatened in an economy attempting to adjust to increased foreign domination both here, at home and abroad. These adjustments should not be made more difficult by placing an additional, if not a crippling, tax burden on the shoulders of self-insuring funds and their members, the American small businessmen.

In conclusion, we really do appreciate the consideration that you are giving to these bills, and it will solve the problem. The legislation currently before this committee will facilitate the ability of small businesses in Michigan, and indeed, throughout the United States, to work together to satisfy the tremendous burden of providing workers' compensation to injured employees and their families. In short, these two bills will save jobs, increase worker efficiency, which, in turn, will contribute significantly to the economic strength and the prosperity of the entire nation.

Thank you.

[The prepared statement follows:]

THE MICHIGAN ASSOCIATION OF TIMBERMEN

"Our Renewable Resource"

April 7, 1987

The Michigan Association of Timbermen support H.R. 1489, introduced by Congressman Guy Vander Jagt and H.R. 1709 introduced by the entire Michigan congressional delegation.

We are a trade association that represents over 700 small businesses in Michigan's forest industry. Our members have an average of 6-10 employees which support nearly 7,000 households. They are all small businesses struggling to survive in a tough regional and world market. Timbermen members supply raw materials to large corporations who are also attempting to remain viable and to better compete against Canadian softwoods, Brazilian wood pulp, and products from other subsidized foreign forests.

Our members are vital to the economy of rural forested communities. In fact, through the harvesting of timber and the production of lumber, Timbermen members are the basic foundation of Michigan's $4.1 billion forest products industry. This is an industry that employs one out of 15 manufacturing employees in our state. Without the harvesting of timber, this economic activity would never occur.

Forestry is one of the four target industries in Michigan's economic development program. The target industry designation is an aggressive effort to focus on areas of strength and excellence in Michigan as we diversify our economy. Forestry was selected as a target industry because it is based upon a renewable resource. In fact, we are currently harvesting less than 40% of our annual growth of forest crops.

What's our problem and why are we here today supporting H.R. 1489 and H.R. 1709? The Timbermen operate Michigan's first self-insuring fund group. In our early years, the insurance industry was charging as much as $44 per $100 of payroll for workers' compensation premium. This was a prohibitive cost that was bankrupting our members. We borrowed upon insurance option ideas that had been developed in South Carolina, Florida, and other parts of the southeast and started the self-insuring group.

Self-insuring funds are a simple and efficient method for small employers to meet their workers' compensation liability obligations. We collect premium contributions and place 80% of these monies in a claims fund. The balance is used to run an aggressive safety and loss control program and to acquire reinsurance for catostrophic losses. We also hire a third party administrator who processes all claims.

All surplus contributions are returned to members. This surplus is returned immediately upon authorization of our regulator, the Michigan Department of Labor.

During the first twelve years of operation, our workers' compensation premium rate has been as low as $9 and is today at $15 per $100 of payroll for loggers. This is a major reduction from the $44 rate charged earlier by insurance companies.

IRS claims we owe over $500,000 in back taxes from the operation of our self-insuring fund for the tax years 1982, 1983, and 1984. We disagree with their new assessment of self-insuring fund tax liabilities. Our self-insuring fund has consistently filed tax returns following procedures of similar operations throughout the United States. These filings have been reviewed positively in numerous IRS private letters issued to similar self-insuring funds.

We have been told that our liability could even be more than $500,000 if we resist this attack by the IRS. In fact, the tax bill for one self-insuring fund increased tenfold when it chose to protest the action of this federal agency.

There are now 38 groups of this type in Michigan, but this is not just a Michigan problem. Self-insuring funds in 25 other states will be threatened by IRS in a similar fashion if H.R. 1709 is not passed.

Self-insuring funds provide the lowest cost method of covering workers' compensation liability. These costs are kept low by active safety and loss control programs. We had early support from labor unions in our state because of our emphasis on safety, loss control, and rehabilitation to benefit workers.

In summary, the Michigan Association of Timbermen Self-Insuring Fund has saved many of our members from bankruptcy. In fact, we have refunded in excess of $10 million to our members during the first twelve years of operation. Additionally, nearly $6 million of discounts further reduced their workers' compensation premium costs during this period. Self-insuring funds in Michigan and other parts of the country have provided the only alternative to standard insurance industry coverage for small businesses. In Michigan, self-insuring funds currently cover over $100 million of approximately $500 million of workers' compensation premium.

The United States must do everything possible to remain competitive in the world marketplace in all segments of our business and industry. Innovations in reducing insurance costs while producing a more safe work environment should be encouraged not taxed out of existence by a zealous tax-collecting agency. Our members are small businesses without any administrative staffs to fight and resist the increasing number of regulations that they are faced with every year.

Our small business members are the foundation of Michigan's forest products industries, just as small businesses are the backbone of the entire United States economy. Neither the State of Michigan nor the United States can afford to see a $4 billion industry threatened in an economy attempting to adjust to increased foreign domination of key industries formerly dominated by the United States, both here at home and abroad. These adjustments should not be made more difficult by placing an additional, if not crippling, tax burden on the shoulders of self-insuring funds and their members, the American small businessmen.

In conclusion, Congressmen, the Michigan Association of Timbermen believe that H.R. 1489 and 1709 will help solve this problem. The legislation currently before this committee will facilitate the ability of small business in Michigan, and indeed, throughout the United States to work together to satisfy the tremendous burden of providing workers' compensation to injured employees and their families. In short, H.R. 1489 and H.R. 1709 will save jobs and increase worker safety, which in turn will contribute significantly to the economic strength and the prosperity of the entire nation.

Presented by Peter C. Grieves on April 7, 1987 before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means

Chairman **Rangel**. Thank you, Mr. Grieves.

Mr. Flippo?

Mr. **Flippo**. The only question I have, Mr. Chairman, I would like to direct to Mr. Nolan. Mr. Nolan, do you think that it is going to be very difficult to draft legislation that would solve the problem that we are trying to address here without opening the door and making a much bigger problem.

You are a craftsman in this field and that is one of the reasons why I ask you.

Mr. **Nolan**. I think it can be done. I think it is a difficult problem, but no more difficult than hundreds of others that we have been able to resolve in drafting the Internal Revenue Code.

Mr. **Flippo**. Well, let me ask you, then, do you prefer a very tightly drafted solution to this kind of problem or do you prefer the broad approach of a total exemption under the 501(c) program?

Mr. **Nolan**. I have not studied the problem of the pooled funds sufficiently to feel assured that making any answer with respect to their problems. I am focusing on the State funds, and I would rather leave it to the pooled funds people to answer that question.

Mr. **Flippo**. Well, we have some really good craftsmen, but I just think that it is possible to draft such legislation.

And I thank the chairman and Mr. Vander Jagt.

Chairman **Rangel**. Mr. Vander Jagt?

Mr. **Vander Jagt**. Thank you, Mr. Chairman. My appreciation to you for moving these hearings along. The progress on solving this problem is so great and the lunch hour is so near over that my questions will be very, very brief.

But I just wanted to ask, Mr. Nolan, you have pointed out that because the not taxing of these funds rests on constitutional principles rather than spelled out, that there is a great deal of uncertainty.

Mr. **Nolan**. That is right.

Mr. **Vander Jagt**. And when you add to that the self-insured funds, for example, in Detroit the IRS itself withdrew in order to reevaluate its position, so the $18 million deficiency is hanging there.

When you add to that the different treatment of the funds right now in different regions of the country, wouldn't you say that what Mr. Stahl calls a road map or what you call certainty is indeed something that Congress should give.

Mr. **Nolan**. I certainly think it is. I think it is very important in this area because the IRS has raised this problem and we need to have a clearcut statutory solution.

I might observe there was some discussion earlier on the basis of questions by Mr. Rangel, and this is just an aside, but I will offer it gratuitously anyway, as to whether the Treasury Department should consider equitable factors in resolving this issue.

Having been at the Treasury Department myself, I can assure you that is entirely feasible. There is a code provision, section 7805(b), which empowers the IRS to determine the extent to which rules and regulations should be made prospective only in effect, which means nonretroactive in effect. Therefore, they have the power to deal with problems of retroactivity when they arise in this context.

I have the feeling from hearing the testimony today the biggest part of this problem is the retroactivity problem. That is, the rules have changed. Clearly the IRS has adopted a new policy for dealing with this area, so they have the power to deal with the retroactivity problem.

It is unfortunate that they have not done so, but having not done so it seems to me clear that the Congress has to deal with this problem and specify what the tax treatment of these various organizations should be, both retroactively and prospectively.

Mr. **Vander Jagt**. Mr. Stahl, I think that you maybe have a great advantage in that you are not a lawyer.

Mr. **Stahl**. I am, sir. Unfortunately, I am.

Mr. **Vander Jagt**. Well, you didn't approach it as a lawyer. You said it just seems to you in common sense that if there is no net income there is no tax. And as I have looked at the narrow dispute that IRS has right now in, especially, leveling the deficiencies, there really wouldn't be any problem at all if the funds—and I would like anyone to correct this if my impression is incorrect. That there would be no problem at all if the funds could pay out the dividend when they declare it because then at the end of that fiscal year there would be no net income or nothing to tax. And the problem is they can't pay out the dividend that they have declared until the State has approved the pay-out.

But for that, we wouldn't have any claim by IRS that anything was subject to taxation.

Mr. **Stahl**. I think that is correct, Congressman. If I could just add, I think getting back to the critical distinction between a self-insurance fund and a company, the reason the State requires you to hold onto that money is we have very slim solvency. We don't have much of a cushion there to fall back on, and that is why they require you to hold onto the funds.

But you are exactly right. But for that problem, apparently the IRS would not have a problem, either.

Mr. **Vander Jagt**. Yes. I didn't mean to suggest that the State—

Mr. **Stahl**. No. I understand.

Mr. **Vander Jagt** [continuing]. For good and sufficient reason has to give an approval. But for that, we wouldn't have any problem at all.

Mr. **Stahl**. I agree.

Mr. **Vander Jagt**. So I think your commonsense approach, even if you are a lawyer——[Laughter.]

Mr. **Nolan**. Lacking common sense, I will try to address that issue.

What you say is almost entirely correct, but there is a problem in that there is a cushion built up in these funds because it is necessary to have such a cushion. As the demands for insurance grow, and they have grown enormously in Michigan over the years from small businesses, that cushion has to grow. To that extent, you are not paying back those premiums currently as policyholder dividends. They eventually will go back to the policyholders. But you are not paying them back currently to that extent, and therefore there is a problem of current taxation, to that extent.

Mr. Vander Jagt. So an area for this subcommittee to explore would perhaps be something that taxed investment income but not the refund.

Mr. Nolan. That would certainly be a feasible approach to this problem. For many years, many insurance companies, as you probably remember, were taxed only on their investment earnings, and there was a good reason for that and it may have application here as well.

Mr. Vander Jagt. Mr. Grieves, you bring us the common sense of the Upper Peninsula of Michigan, and as I understood the gist of your testimony is that the reason the self-insured groups are able to provide lower cost insurance is not because they are not taxed, but because they have the self-interest of the self-insurers, and, therefore, promote safety and rehabilitation and peer pressure, and that this has worked very, very well in making available lower cost insurance.

I think the gist of your testimony was that IRS now wants a drastic change of the policy that they have followed for 20 years, and you bring us the word, if it ain't broke, don't fix it.

Mr. Grieves. That is right. And I wish the committee could have been at my trustees' meeting last Saturday in Escanaba, Mich., where my board of trustees called in 10 other fellow businessmen because they had lost records that they deemed inadequate, and asked them in a friendly way what are you going to do about it. And I think those of you who have been in business knows that would have an impact.

And I would like to make one comment on investment income. Our association from its inception has refunded investment income annually up to 4 years ago. Four years ago we started doing it every 6 months, so we have a Christmas refund. And that is popular.

Mr. Vander Jagt. Well, I would like to thank each member of the panel. And again, thank you, Mr. Chairman.

Chairman **Rangel.** Thank you, Mr. Vander Jagt for bringing this complex and serious matter before the subcommittee, and we thank the panel for your enlightened testimony.

This subcommittee will stand adjourned.

[Whereupon, at 12:51 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

SUBCOMMITTEE ON SELECT REVENUE MEASURES

APRIL 13, 1987

TESTIMONY REGARDING H.R. 1709

MAY IT PLEASE THE COMMITTEE:

Worker's compensation self-insurance funds in the State of Louisiana have gained wide acceptance by the employer community as a cost-effective and safe way to provide for their liability to injured employees. Enabling legislation authorizing these funds was passed in our legislature in 1979, and several of the funds that we service have been in existence, in full operation, since that time. They presently account for more the $14,000,000 in premium volume. Total self-insured premiums in the state are probably well in excess of $30,000,000. We have found that the concept of self-insurance works so well for several very important reasons:

1. The commercial insurance market has failed to provide consistent, reasonable cost coverage. Many of the employers covered by these plans would otherwise be allotted to the assigned-risk pool.

2. The idea of establishing a "peer group" board of trustees to administer the program, who are themselves members of the group being insured, promotes such worthwhile goals as heightened safety-consciousness, better hiring practices, and, as a result, better competitiveness in the marketplace.

3. The notion that an employer can recoup some of his premium dollars if the experience of the group is good is one that is particularly well-accepted by the members of our funds. To top it off, it even makes good old-fashioned common sense.

Apparently, it doesn't make sense to the Internal Revenue Service. For reasons known only to it, the Service is ignoring well-established precedents of the tax court relative to the surplusses enjoyed by these efficient and safety-conscious groups, and is taking the position that such surplus is taxable. The Service's position revolves around two principal arguments.

First, the Service says, such funds are not "mutual insurance companies", and therefore ought to be treated for tax purposes as if they are insurance companies engaging in business for profit. This argument is not well founded. Several characteristics that all of our funds share make it clear that they are not engaging in the insurance business for profit:

(Note here that LA. R.S. 23:1191, the enabling legislation for these funds in Louisiana, specifically states that these funds are created for the sole purpose of retaining the risk by these employers, and that it "shall not be considered to be insurance".)

1. The funds exist for the sole stated purpose of providing their members with worker's compensation coverage in the most efficient way and at the lowest cost possible-AT COST. Dollars not spent for claims payments or for the reasonable costs of the administration of the fund must be returned to the membership.

2. By law, the class of employers who can be members of each fund is limited to those doing the same or substantially the same type of business.

3. These members own, in indivision, the assets of the fund, and are liable solidarily for worker's compensation benefits that exceed the ability of the fund or the reinsurance to pay.

Second, the Service, in its position against a Michigan fund, makes an argument that a fund may not take a deduction for "dividends to policyholders" until both the fund's trustees and the Department of Labor have approved such, because until then, it is too contingent to be deductible. Because of the fact that all of our funds' by-laws require return of unallocated dollars to the members, the Service's position is in error. The fact that state laws require us to hold on to these surplusses for 1 1/2 years (longer than a mutual can hold them and still get favorable tax treatment) should in no way affect the answer to the tax policy question presented by this bill. OUR FUNDS HAVE NO PROFIT. NO GROSS PROFIT. NO NET PROFIT. NO PROFIT.

In summary, it is our position, and that of the funds that we service that their self-insured worker's compensation programs are not businesses operating "for profit", and that any funds that accrue to them through the payment of interest or otherwise is simply and purely a mechanism for the funding of liabilities that they may incur while trying to make a living in America. With the state of the economy in Louisiana, the members of our funds wouldn't dream of being in the business of insurance. They dream of being in the business of business.

Respectfully submitted,

Stephen Cavanaugh

Stephen Cavanaugh, Louisiana Manager
ADJUSTCO, INC.

Statement of

Alliance of American Insurers
National Association of Independent Insurers
National Association of Mutual Insurance Companies

on H.R. 1489 and H.R. 1709

before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives

April 7, 1987

We appreciate the opportunity to present our views on H.R. 1489 and H.R. 1709, bills that would grant a tax exemption to so-called self-insured workers compensation or workers disability funds. The Alliance, the NAII and NAMIC are trade associations representing over 1,500 property and casualty insurance companies that provide insurance protection across the United States, and they write close to 35% of the workers compensation insurance coverage provided in the U.S.

Our members participate in one of the most intensely competitive businesses in our country. They welcome competition. They cannot, however, support the unfair competition that would arise if their competitors are given tax-exempt status in the Internal Revenue Code. For this reason we must oppose H.R. 1489 and H.R. 1709, and believe that self-insured workers compensation funds should be taxed as mutual insurance companies. We must also reiterate that the Internal Revenue Code provides that all insurers using the National Association of Insurance Commissioners' annual statement method of accounting are generally allowed to deduct policyholder dividends in the taxable year in which they are declared, rather than the year in which they are paid.

I. H.R. 1489/H.R. 1709

These bills would grant a complete federal income tax exemption for "self-insured workers' compensation or workers' disability fund(s)". These funds are creations of state law that compete directly with "commercial" workers compensation insurers (mutual and stock) in providing workers compensation coverage to employers. Commercial workers compensation insurers, of course, including mutuals, are fully taxable -- in fact, the Tax Reform Act of 1986 adds $7.5 billion in tax payments to the property/casualty insurance industry's tax bill during the years 1987-1991. It is clearly unfair to require taxable insurers to compete in providing exactly the same insurance coverage with groups that are made tax-exempt by statute.

Group self-insured workers compensation funds have been formed in a manner very similar to the formation of many commercial mutual property/casualty insurers. In fact, the phrase "self-insurance" is somewhat of a misnomer, since the employers in the groups are spreading and transferring their workers compensation risk, just as insurers do. A large number of mutual companies began as groups of persons with particular types of risks (employers, lumbermen, farmers, druggists, florists, etc.) who felt that the existing insurance market was not meeting their needs. Those origins are reflected in the names of many companies. These companies have always been competitors in the commercial insurance marketplace, and have since 1942 (except for the smallest companies, which continue to be eligible for reduced or no tax liability under the 1986 Act) been subject to the federal income tax.[1] They welcome new competition. What they cannot welcome is competition unfairly subsidized by a federal tax exemption. Group self-insurance workers compensation funds provide the same insurance coverage as commercial insurers do, and operate in much the same fashion as mutual insurers. In all fairness, they should be taxed the same way, as mutual insurance companies.[2]

II. Treatment of policyholder dividends

Because the use of ordinary accrual or cash basis tax accounting methods distorts an insurance company's income, Internal Revenue Code Section 832 generally requires property/casualty insurance companies to use the accounting method prescribed in "the annual statement approved by the National Association of Insurance Commissioners." 26 U.S.C. Sections 832(b)(1)(A), (b)(6). Although the Internal Revenue Service has often disagreed, the courts have, with few exceptions, required use of the annual statement method for tax purposes. See Bituminous Casualty Corp., 57 T.C. 58 (1971); Continental Insurance Co. v. U.S., 474 F.2d 661 (Ct.Cl. 1973). Code Section 832(c)(11) also provides that policyholder dividends are deductible in the year in which they are "paid or declared...according to the method of accounting regularly employed" by the company. The annual statement method of accounting, to which property/casualty insurers are automatically subject by state law, generally requires policyholder dividends to be reported as a liability in the year in which the dividends are declared by the insurer's board of directors. The annual statement treatment of policyholder dividends was specifically upheld in Bituminous Casualty Corp., supra, a decision in which the Service has acquiesced as to this issue. 1972-2 C.B. 1. Thus an insurer using the annual statement method of accounting may generally deduct policyholder dividends in the year in which they are declared. If a group self-insured workers compensation fund uses the annual statement method to keep its books, it should be entitled to the same treatment.

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[1] It should be noted that, for taxable years beginning in 1987 and thereafter, the Tax Reform Act of 1986 has eliminated the tax law distinctions between mutual and stock property/casualty insurance companies (except for mutual companies phasing out their protection against loss accounts).

[2] Small funds may, of course, qualify for treatment as small insurance companies and thereby incur reduced tax liability.

AMERICAN INSURANCE ASSOCIATION
LAW DEPARTMENT

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AMERICAN INSURANCE ASSOCIATION STATEMENT ON H.R.1489 AND H.R.1709 BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES

APRIL 15, 1987

We appreciate the opportunity to present our views on H.R.1489 and H.R.1709, bills that would grant a tax exemption to so-called self-insured workers' compensation associations. The American Insurance Association, (AIA) represents 171 stock property-casualty insurance companies, which write multiline coverage throughout the United States. Their combined premiums in 1985 represented more than 25% of the property and casualty insurance premiums in the United States. In 1985, our members provided over 34% of the workers' compensation insurance coverage in the nation.

The property and casualty insurance industry is one of the most competitive businesses in the United States. AIA's members welcome fair competition. However, they cannot support the unfair competition that would arise if groups that compete with them are given tax-exempt status under the Internal Revenue Code. For this reason, our companies strongly oppose H.R.1489 and H.R.1709 and believe that self-insured workers' compensation associations should be taxed as insurance companies. Furthermore, we believe these associations should be subject to all other state and federal laws which apply to commercial insurance companies.

H.R.1489 and H.R.1709 would grant a total federal income tax exemption under 501(c) of the Internal Revenue Code for "self-insured workers' compensation or workers' disability funds." The bills are aimed at self-insured associations which are formed by employers of a common industry that voluntarily pool funds to insure their collective workers' compensation. Each employer's annual contribution is based on the size of the employer's work force and its experience with workers' compensation claims. The association draws on the pools to pay workers' compensation benefits to employees of participating employers. All claims are made against and paid out of the pooled funds. The structure of these associations differs depending upon state law and the terms of the agreement among the employers.

EDWARD H. BUDD
CHAIRMAN
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ROBERT E. VAGLEY
PRESIDENT

We agree with the Treasury in its testimony before the Subcommittee on April 7th that granting a 501(c) tax exemption to these associations is clearly inappropriate. As the Treasury stated, " unlike charitable, religious and educational organizations, which are granted tax-exempt status because of their special, quasi-public purposes, workers' compensation associations are operated for the exclusive benefit of the participating employers." Furthermore, Congress made clear in the Tax Reform Act of 1986 that an organization is ineligible for tax exempt status if its activities consist of providing commercial type insurance. We believe that the same principles that guided Congress to deny tax exempt status to other such organizations should also apply to self-insured workers' compensations associations.

We believe that if workers' compensation self-insurance associations possess the requisite characteristics of insurance companies, they should be taxed as such. As the Treasury Department noted in its testimony, for tax purposes an insurance company is a company whose primary and predominant business activity is the issuing of insurance or annuity contracts. An insurance contract is one that involves the shifting and distribution of risk among a group of economically unrelated entities. A workers' compensation self-insurance association must meet these requirments in order to be taxed as insurance and not self-insurance. Therefore, to the extent that employer contributions to these funds are at risk to pay claims attributable to other employers and distributions are based on the experience of the association as a whole rather than of individual employers, the association exhibits the risk shifting and risk distribution characteristics necessary to be an insurance company. This is true even though the state authorizing statutes may consider them a form of self-insurance.

On the other hand, as the Treasury points out, an employer will be treated as self-insuring its workers' compensation liability if it retains the economic risk of loss. In this case, the association must be treated as providing self-insurance and taxed accordingly.

Commercial workers' compensation insurers are fully taxable. In fact, the Tax Reform Act of 1986 adds $7.5 billion in new tax payments from the property-casualty industry during the years 1987 to 1991. Granting tax-exempt status to self-insured workers' compensation associations that possess all the requisite characteristics of insurance would put our members, and other taxable insurance companies, at an unjustifiable competitive disadvantage. These associations provide the same insurance coverage as commercial insurers do and operate in much the same fashion. They compete directly with commercial insurers in providing workers' compensation insurance. In all fairness, they should be taxed and treated the same as commercial insurers.

A STATEMENT BY
THE HONORABLE WILLIAM S. BROOMFIELD
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS

April 7, 1987

Mr. Chairman and Members of the Subcommittee, I appreciate this opportunity to present my views regarding the Internal Revenue Service's actions against the Workers Compensation Self-Insurance Funds in Michigan.

While this may currently be a Michigan problem which affects 37 self-insurance funds in the state, the matter has much broader implications because businesses in 25 other States either operate or participate in such funds.

These funds have been servicing the workmen's compensation needs of small businesses since the early 1960s, and in Michigan since 1974. These funds are made up of groups of employers in the same industry, who individually lack sufficient funds to self-insure, but who have pooled their resources to meet the Workers Compensation requirements and obtain the benefits of reduced costs and greater control of claim resolution available to self-insurers.

Common among them is that they serve as conduits for their members in meeting claims. The funds collect premiums, pay claims and expenses, handle reserves called for by the state, and return any excess funds to the member businesses. Because of this sole responsibility as a conduit, they have been filing their taxes in good faith over the years as mutual insurance companies. These filing practices have also been in conformance with three private letter revenue rulings issued within the last five years.

However, last year these funds found their position in jeopardy. Early last year the Detroit District Office of the Internal Revenue Service began auditing these funds and by changing the "rules", submitted a Notice of Deficiency against one of the major funds in Michigan, the Detroit Tooling Association Worker's Compensation Fund, for deficiencies in it's income tax for 1982, 1983, and 1984 of more than $18 million.

Mr. Chairman, you have heard from Mr. Richard L. Moore, the Administrator of the Detroit Tooling Association Worker's Compensation Fund, and he has discussed the economic implication of this finding for his fund, its 700 member companies, and their more than 7,000 employees. Because all of the funds are basically structured the same, there is obvious concern that the other funds in Michigan, and perhaps the other states, will also find themselves confronted with the same problem.

To try and resolve this matter, Congressman John Dingell and I and the rest of the Michigan Congressional Delegation urged the General Counsel of the IRS to meet with several of these fund administrators to discuss the IRS's actions, and to see what might be done. Unfortunately, this meeting did not provide any relief, and so under the leadership of Congressmen Vander Jagt and Dingell, and again with the full support of the Michigan Delegation, provisions were added to last year's Tax Reform Act to have a one-year moratorium on all IRS audits, tax deficiencies and U.S. Tax Court filing deadlines regarding the self-insurance funds.

Mr. Chairman, the question must now be how can this matter be resolved fairly. I would again point out that because of their practices as a conduit of funds for their member companies and with the opinion of IRS private letter rulings, the self-insured funds were filing their taxes as mutual insurance companies in good faith. The Tax policy that is established will have serious implications to the funds in Michigan and to the other 25 states as well. Further, if the IRS is allowed to find that these funds owe taxes retrospectively, the effect would be devastating to the funds, their member companies, and to their employees. To allow this to happen would be unconscionable in my opinion.

The Subcommittee has before it a bill introduced by Congressman Vander Jagt, H.R. 1709, which I and most of the Michigan Delegation have cosponsored. I believe it provides a reasonable and equitable resolution of this problem, and I would encourage its adoption by the Subcommittee.

Mr. Chairman, I wish to again thank you and the Members of the Subcommittee for this opportunity to present my views on this issue.

STATEMENT BY
THE HONORABLE JOHN D. DINGELL
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS
April 7, 1987

Mr. Chairman, and distinguished Members of the Subcommittee. I appreciate the opportunity to submit my views to the Subcommittee on a matter which is of great importance to my constituents and thousands of small businesses in Michigan, and in 25 other States, that either operate or participate in Workers Compensation Self-Insurance Funds.

Mr. Chairman, this complex problem was brought to my attention in February, 1986, by Richard L. Moore, Administrator of the Detroit Tooling Association Workers Compensation Self-Insurance Fund, located in my Congressional District, and by representatives of the Michigan Beer and Wine Wholesalers Association and the Michigan Retailers Association.

Mr. Moore and his associates stated that certain agents from the IRS Detroit Office were auditing their fund's alleged tax deficiencies for tax years 1982, 1983 and 1984. They said IRS agents had indicated to them that all 37 self-insurance funds throughout Michigan would be similarly audited. Mr. Moore and his associates presented a forceful case that the IRS was without statutory or regulatory foundation to make tax deficiency findings. They argued their funds satisfy the statutory requirements of being a mutual insurance company, and as mutual insurance companies previous IRS rulings had held that the reserves or distributions of such funds were not taxable.

Because the Michigan funds had relied on these IRS policies, I thought it to be highly unfair for the IRS to issue any tax deficiencies for past tax years. I also thought it was highly unfair that the IRS was auditing only Michigan funds, and not the funds in any other state, without any clear and convincing policy that such audits or tax determinations were justified.

On March 6, 1986, I wrote the IRS Commissioner requesting a justification of this policy. The IRS was unable to provide me with a satisfactory explanation as to why it could, under the law, issue tax deficiencies against these funds, or why it was auditing only Michigan self-insurance funds. I also corresponded with, and personally met with, IRS Detroit Office Director John O. Hummel. Likewise, Mr. Hummel was unable to provide a satisfactory explanation why Detroit-based IRS agents were continuing to audit these funds.

Ultimately, the IRS issued a tax deficiency notice against the Detroit Tooling Association for in excess of $18 million, and served tax deficiencies on several other funds amounting to millions of dollars. At the urging of Congressman William S. Broomfield and the entire Michigan Delegation, the General Counsel of the IRS, Mr. William Nelson, met with several of these funds to discuss the propriety of the IRS actions. The funds, however, received no relief.

During the pendency of these events, I thought it most appropriate that the House Ways and Means Committee should investigate the matter. I wrote several letters to Congressman Pickle requesting that his Oversight Committee look into this matter. Because of the heavy legislative schedule with the 1986 Tax Reform Bill, the Subcommittee was unable to conduct a hearing.

Because of the unfairness of how the IRS was proceeding on this matter, Congressman Guy Vander Jagt, myself, and the Michigan Delegation, asked Chairman Rostenkowski to incorporate in the 1986 Tax Reform Bill a one-year moratorium on all IRS audits, tax deficiencies and U.S. Tax Court filing deadlines regarding the self-insurance funds. The Conference Committee acquiesced to our request and included language in the final version of the Tax Reform Act.

The question now before the Subcommittee is how it will clarify a most questionable and ambiguous IRS policy in a manner that will not impose unreasonable financial burdens on these funds. The 37 funds in Michigan alone provide workers compensation insurance to more than 7,000 employers at a substantial discount--in some cases in excess of 50 percent--over what these companies would pay if they were forced to shoulder the exceedingly high cost of traditional workers compensation insurance. The Detroit Tooling Association alone represents 700 companies employing approximately 40,000 workers.

The ultimate tax policy formulated by Congress will not only have a substantial impact on Michigan, but will affect 25 other states that, by state law, permit similar funds to operate. If the IRS is permitted to impose tax deficiencies, particularly for past tax years, against funds throughout the Nation, the impact will be devastating--in terms of social costs, human costs, and unbearable financial burdens.

As hundreds of self-insurance fund providers are forced into insolvency, the cost of workers compensation for thousands of small and struggling businesses will become prohibitive, forcing them into bankruptcy and out of business. As a result, thousands of workers will be forced into unemployment lines and onto welfare rolls. Such an unbridled policy would strike a crushing blow to small business in this country unmatched by any misguided tax policy in history. The retrospective application of such a tax policy--not foreseen by small business, and costing millions of dollars of unanticipated tax liabilities, would be unconscionable.

I am aware the Subcommittee has before it legislation introduced by Congressman Guy Vander Jagt, H.R. 1709, cosponsored by myself and most of the Michigan Delegation. The bill essentially would make the operation of these funds tantamount to a 501(c)(3) not-for-profit concern. The bill represents a fair and equitable resolution to the problems faced by these funds, and I strongly support its provisions and urge its adoption by the Subcommittee.

However, should the Subcommittee decides not to embrace the provisions of H.R. 1709, and instead chooses to adopt a policy that subjects the transactions of these funds to some form of taxation, that policy should only apply prospectively, and not retrospectively. On the basis of equity and fairness alone, the IRS should not be allowed to tax past tax year transactions where no clear policy taxation policy existed to guide the financial planning of these small companies.

I thank the Subcommittee for considering my views.

STATEMENT OF
THE SELF-INSURANCE INSTITUTE OF AMERICA, INC.
TO
SUBCOMMITTEE ON SELECT REVENUE MEASURES
WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENATIVES
ON
TAXATION OF WORKERS' COMPENSATION FUNDS

This statement is submitted on behalf of the Self-Insurance Institute of America, Inc. ("SIIA"), a national association of over 600 members including employers, third-party administrators, primary insurance companies, reinsurance companies and other interested parties dedicated to the improvement of the self-insurance industry.

SIIA wishes to go on record in support of legislation introduced by Representative Guy Vander Jagt (HR 1709) which provides for the continuation of the tax-exempt status of workers' compensation self-insurance funds.

Group workers' compensation self-insurance funds have had a long and significant history in providing the lowest cost and most efficient means for employers to meet their workers' compensation obligations in various State jurisdictions. This alternative approach has been used in some jurisdictions for more than 50 years and has enjoyed significant and effective usage for more than a quarter of a century.

The group self-insurance approach to the purchase of first-dollar coverage has been instrumental in the economic health of many businesses. Often, the purchase of standard insurance products has been found lacking by small businesses because of their high cost as well as their failure to appropriately address the effective claims management and safety needs of employers. Employers who pursuant to state authority are allowed to band together to provide a self-insurance fund do so in a regulated and economically safe manner. Group self-insurance programs have existed for many years with solvency experience superior to that of insurance companies providing products for the same purpose.

Among the incentives to employers who form group self-insurance funds is the knowledge that all monies that are not necessary to pay needed expenses or claims will be returned. Additionally, self-insured groups have been shown to be superior in the delivery of safety and claims prevention services to small businesses. These funds encourage employers to work together to reduce the frequency and severity of claims, resulting in a safer work place and one which is less costly and more economic to the benefit of all interested parties, including the employees and the employer.

It has been suggested by some that these group self-insurance funds should be taxed as if they were insurance companies. While some of these funds may appear to have certain characteristics of insurance companies, they lack the most relevant characteristics that make insurance companies a unique form of business organization. While employers share risk in group self-insurance funds, primarily through their payment to support the cost of those funds and their involvement in protecting the funds through joint and several liability agreements, the funds do not purport to sell to the general public, but rather provide services to their members only.

Many of the state statutes providing for group self-insurance funds require that employers be in the same or in similar industry categories in order to participate. This rule enhances the ability of the employers to provide improved safety and claims-prevention measures and limits even further their involvement with the general public. Moreover, group self-insurance funds, unlike insurance companies, have a long track record in returning the surplus dollars not needed to pay claims or related expenses back to the members. At this point, the monies returned are taxed to the members. The standard insurance industry's experience in returning funds is erratic and the dollars returned to policyholders related to the dollars collected is relatively small. The group funds, on the other hand, exist only to provide those limited services to their members. The group funds have no need to maintain reserves for other reasons and, therefore, return the unneeded surplus as soon as it is practicable and allowable under state law.

Group self-insurance funds have been shown to be well-regulated by the various state regulatory authorities that currently maintain this control. The group self-insurance funds have not suffered the enormous rash of insolvencies that have struck the standard insurance industry but rather have shown themselves to be more stable and secure. To treat group self-insurance funds as if they were insurance companies for taxation purposes or otherwise would be to tamper with an efficient and effective form of providing needed coverage at the lowest price. These funds have experienced decades of consistent Internal Revenue filing practices and to change their status now, whether as a means of revenue raising or for some other purpose, would be extremely damaging and unfair.

Finally, the safe, efficient, and effective method of handling workers' compensation obligations, has allowed many individual businesses and industries to remain in existence while providing full and necessary coverage for their injured employees. To alter the way these funds have been treated traditionally would serve no real purpose and will only result in a harrassment to small businesses struggling to continue to remain economically strong.

Thus, SIIA strongly supports HR 1709 and urges its adoption by the Subcommittee.

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